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New Guidance to Consider for 2021–2022 Attest Engagements

As you plan for the 2022 nonprofit attest season, there are several new standards to keep in mind. The following paragraphs highlight new guidance from the FASB and AICPA that is effective for fiscal years ending June 30, 2022, and beyond.

FASB Accounting Standards Updates (ASUs)

ASU 2020-07, *Not-for-Profit Entities (Topic 958): Presentation and Disclosures by Not-for-Profit Entities for Contributed Nonfinancial Assets*. ASU 2020-07 adds new presentation and disclosure requirements for contributed nonfinancial assets (gifts-in-kind). The ASU requires gifts-in-kind to be presented as a separate line in the statement of activities. It also requires additional disclosures, including disaggregation into categories based on the type of gift received, and qualitative disclosures for each category of asset. The amendments are effective for annual periods beginning after June 15, 2021, and should be applied on a retrospective basis to all periods presented.

ASU 2021-01, *Reference Rate Reform (Topic 848): Scope*. The FASB issued ASU 2021-01 to expand the scope of the practical expedients allowed by ASU 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting*. Under ASU 2020-04, a contract must reference an index or rate that has been or is expected to be discontinued because of reference rate reform to qualify for certain expedients and accounting exceptions. ASU 2021-01 clarifies that derivative contracts that do not reference such a rate but that are affected indirectly by reference rate reform because of market-wide changes in the interest rate used for margining, discounting, or contract price alignment, are explicitly eligible for certain optional expedients and exceptions in FASB ASC 848. ASU 2021-01 was effective upon issuance (January 7, 2021). As with ASU 2020-04, the relief provided by ASU 2021-01 is temporary and ends after December 31, 2022.

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ASU 2021-03, *Intangibles—Goodwill and Other (Topic 350): Accounting Alternative for Evaluating Triggering Events*. ASU 2021-03 provides an accounting alternative to perform the goodwill impairment triggering event evaluation as of the end of the reporting period, whether the reporting period is an interim or annual period. If the alternative is elected, there is no requirement to monitor for goodwill impairment triggering events during the reporting period but, instead, an entity should evaluate the facts and circumstances at the end of the reporting period and determine if a triggering event has occurred. If a triggering event is identified, a goodwill impairment test would be performed. Because the ASU was issued in response to economic uncertainties caused by the COVID-19 pandemic, this accounting alternative is allowed for fiscal years beginning after December 15, 2019. Also, ASU 2021-03 provides an unconditional one-time option that allows the adoption of the accounting alternative prospectively after its effective date without assessing preferability under FASB ASC 250, *Accounting Changes and Error Corrections*.

Amendments to FASB ASC 842, *Leases*. Two ASUs to amend FASB ASC 842 were issued in 2021. These ASUs are generally effective for fiscal years beginning after December 15, 2021; that is, they are effective concurrently with implementation of the guidance for lessees and lessors in FASB ASC 842.

- ASU 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, provides amendments to allow lessors to classify and account for a lease with variable lease payments that does not depend on a reference index or a rate as an operating lease if certain criteria are met.
- ASU 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, provides amendments to allow lessees to elect to use a risk-free rate as the discount rate by class of underlying asset. Previously, this accounting policy election could only be applied entity wide.

Practical Consideration:

Readers should refer to the FASB ASUs for detailed effective date and transition requirements. *PPC's Guide to Nonprofit GAAP* discusses the newly-effective ASUs as they need to be applied by nonprofit entities. In addition, see the FASB ASC 842 refresher articles in the May (lessees) and June (lessors) issues of *The PPC Nonprofit Update*.

AICPA Authoritative Statements

Audit Standards. Major changes to the auditor's reporting requirements, and other related auditing standards, are contained in Statement on Auditing Standards (SAS) 134 through SAS 140. These statements were issued at various times from May 2019 through April 2020. SAS 141 was subsequently issued to defer the implementation of SASs 134–140 to audits of financial statements for periods ending on or after December 15, 2021. These new audit requirements are discussed in the article, *Audit Report Changes Refresher—Part 1*, of this newsletter.

Attestation Standards. New Statements on Standards for Attestation Engagements (SSAEs) effective in 2022 include SSAE 21 and 22.

SSAE 21, *Direct Examination Engagements*, adds AT-C 206 that create a new service—*direct examinations*—in which the practitioner both measures or evaluates the responsible party's subject matter and examines it. SSAE 21 is effective for reports dated on or after June 15, 2022.

SSAE 22, *Review Engagements*, supersedes prior guidance at AT-C 210 and also is effective for reports dated on or after June 15, 2022. SSAE 22 provides for an adverse conclusion in a review report when there is evidence of pervasive and material misstatement of the subject matter. SSAE 22 also conforms certain concepts in AT-C 210 with those same concepts in SSAE 21.

Practical Consideration:

PPC's Guide to Nontraditional Engagements provides in-depth guidance for performing direct examination engagements in accordance with SSAE 21. It also incorporates the new requirements of SSAE 22.

Accounting and Review Standards. The new Statement on Standards for Accounting and Review Services (SSARS) effective for periods ending on or after December 15, 2021 (2022 year ends for many nonprofit organizations) is SSARS 25.

SSARS 25, *Materiality in a Review of Financial Statements and Adverse Conclusions*, is effective for periods ending on or after December 15, 2021. Among other changes, SSARS 25 includes an explicit requirement to determine materiality for the financial statements as a whole and apply this benchmark in designing procedures and evaluating results. SSARS 25

also revises reporting standards with respect to the accountant's independence, compliance with ethical responsibilities, and issuance of an adverse conclusion when there is evidence of pervasive and material misstatement of the financial statements.

Practical Consideration:

Guidance for implementing SSARS 25 is provided in *PPC's Guide to Compilation and Review Engagements*. Chapter 15 of *PPC's Guide to Audits of Nonprofit Organizations* also incorporates the requirements of SSARS 25.

Auditor Report Changes Refresher—Part 1

Since May 2019 the ASB has issued a suite of standards [Statement on Auditing Standards (SAS) Nos. 134–140] that change the current auditor's report and provide for additional requirements concerning (1) communication with those charged with governance, (2) revisions to the auditor's report on ERISA plan financial statements, (3) auditor responsibility for applying procedures to other information included in annual reports, (4) eliminating inconsistencies between the AICPA and U.S. judicial system on the definition of materiality, (5) technical corrections to align with new auditor reporting language for statements prepared following special purpose frameworks, single financial statements, accounts or items of a financial statement and summary financial statements, (6) supplementary information and required supplementary information to be presented in a separate section of the auditor report, and (7) revisions for consistency regarding OMB's *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance) and *Government Auditing Standards—2018 Revision Technical Update April 2021* (the 2018 Yellow Book). These changes will have a significant impact on audits conducted this year as the suite of standards is effective (as amended by SAS 141) for audits of financial statements for periods ending on or after December 15, 2021.

The Suite of Standards

SAS 134. SAS 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*, supersedes and amends several auditing standards. It replaces AU-C sections 700, 705, and 706; adds 701; and amends section 570. Here are highlights of the changes to the standard auditor's report that auditors should be aware of:

- Moves the opinion closer to the beginning of the report and requires the first section of the report to have the heading "Opinion", followed directly by the "Basis for Opinion" section (unless laws or regulations require a different order).
- Adds a statement to the "Basis for Opinion" section about the auditor's independence and other ethical responsibilities and requirements.
- Requires a section, with the heading "Responsibilities of Management for the Financial Statements," that expands on the description of management's responsibilities already included in auditor's reports to state management's responsibility for assessing the entity's ability to continue as a going concern and whether using the going concern basis of accounting is appropriate.
- Adds a section, with the heading "Auditor's Responsibilities for the Audit of the Financial Statements," that expands on the description already included in auditor's reports.
- Adds an option for the auditor to communicate Key Audit Matters (KAMs) in the report under a separate heading. KAMs are not required to be included in audits of nonissuers. KAMs may include areas of higher assessed risks of material misstatement or significant identified risks, areas of significant management judgments including accounting estimates with high estimation uncertainty, and significant events and transactions that occurred during the audit period.

Practical Consideration:

For many nonprofit organizations, June 30, 2022 will be the first time to implement SAS 134 and the related suite of SASs. For further information and for report examples, please refer to Chapter 13 of *PPC's Guide to Audits of Nonprofit Organizations* and *PPC's Guide to Single Audits*.

SAS 135–140. We'll highlight key changes in the rest of the reporting suite in Part 2 in the August issue of *The PPC Nonprofit Update*.

Converting a Taxable Corporation to Tax-exempt Status

Generally, the contribution of appreciated long-term capital gain property to a qualified charity avoids income tax on the unrealized gain. This can be attractive to a corporation desiring to further the mission of a charity or secure an income tax charitable deduction. However, converting a taxable corporation to tax-exempt status can result in significant tax consequences despite charitable intent and meeting the income tax charitable deduction requirements under IRC Sec. 170. The tax liability produced by such a conversion can be unexpected and harsh.

Let's review some of the rules that apply when distributing property from a taxable entity. Under IRC Sec. 336(a), gain or loss must be recognized by a corporation (C or S) on the distribution of property to its shareholders in complete liquidation of the entity. Gain or loss is determined as if such property were sold at its fair market value (FMV). When property is distributed in complete liquidation to a corporate shareholder who owns at least 80% of its stock (e.g., parent of wholly owned subsidiary), gain or loss is not recognized [IRC Sec. 337(a)].

This nonrecognition treatment does not apply where the 80% distributee is a tax-exempt entity unless the exempt organization uses the distributed property in an unrelated trade or business that is subject to tax on a subsequent disposition [IRC Sec. 337(b)(2)]. If the exempt organization uses only a portion of the property in an unrelated trade or business, the tax-free treatment is available only to that extent.

Section 337(d) Regulations Apply to Tax-exempt Entities

Regulations were issued to ensure gain recognition was not circumvented by using a tax-exempt organization.

Contribution of all or *substantially all* assets. Generally, under Reg. 1.337(d)-4(a)(1), if a taxable corporation contributes all or *substantially all* of its assets to one or more tax-exempt entities, the taxable corporation recognizes gain or loss immediately before the transfer as if the assets transferred were sold at their FMVs.

Substantially all is interpreted based on its meaning under IRC Sec. 368(a)(1)(C) for purposes of Type C reorganizations. While there is no statutory or regulatory definition of *substantially all*, the courts and IRS have looked to the facts and circumstances to determine whether substantially all of the assets of a corporation have been transferred. They focus on the nature of the properties retained by the transferor corporation, the purposes for the retention, and the amount of the assets. If the assets transferred are essential to the historic business operation of the corporation, the transfer will be considered a transfer of substantially all of the corporation's assets. Absent the transfer of these assets, nonbusiness assets, including investments, real estate, and artwork not used in the business operations, should safely be able to be contributed to a charity without triggering gain or loss treatment under the Section 337 regulations.

Advance ruling for determining substantially all assets. A safe harbor exists to meet the *substantially all* assets requirement by obtaining a favorable advance ruling from the IRS. At least 90% of the FMV of the net assets and at least 70% of the FMV of the gross assets (i.e., 90/70 test) that it held immediately before the transfer must be transferred to qualify (Rev. Proc. 77-37, 1977-2 CB 568).

Change of status from taxable to tax-exempt. Similarly, under Reg. 1.337(d)-4(a)(2), a taxable corporation that converts to a tax-exempt entity is deemed to have transferred all of its assets to a tax-exempt entity, triggering the recognition of gain or loss immediately before the change in status is effective.

Exceptions to the change in tax status rule applies. Reg. 1.337(d)-(4)(a)(2) does not apply to the following—

- a previously tax-exempt corporation under IRC Sec. 501(a) that regains its tax-exempt status under IRC Sec. 501(a) within three years from the later of—
  - a final adverse adjudication on the corporation's tax-exempt status, or
  - by filing a federal income tax return of the type filed by a taxable corporation;
- a newly formed corporation that is tax-exempt under Section 501(a) [other than a Section 501(c)(7) organization] within three tax years after the tax year in which it was formed; and
- a newly formed Section 501(c)(7) organization that is a tax-exempt corporation under IRC Sec. 501(a) within seven tax years after the tax year in which it was formed.

Caution: The previous list is not all-inclusive and anti-abuse rules apply.

Practical Consideration:

The conversion of a taxable corporation to a tax-exempt organization or the transfer of substantial assets from a taxable corporation to a charity should be carefully reviewed to avoid unexpected tax consequences.

IRS's Notification Prior to Auto-revoking Certain Form 990-N Filers

Tax-exempt organizations generally must file either an annual information return on Form 990 (Return of Organization Exempt From Income Tax), Form 990-EZ (Short Form Return of Organization Exempt From Income Tax), or an annual electronic notice using Form 990-N [Electronic Notice (e-Postcard) for Tax-Exempt Organizations Not Required To File Form 990 or 990-EZ], depending on the organization's gross receipts and total assets [IRC Sec. 6033(a)]. Exceptions to the filing requirements apply to organizations with gross receipts below a specific amount and to certain religious and governmental organizations.

Form 990-N

Organizations not required to file Form 990 or 990-EZ will generally be required to file Form 990-N. Most small tax-exempt organizations with gross receipts that are normally $50,000 or less must submit the Form 990-N annually [Rev. Proc. 2011-15 (2011-3 IRB 322); Reg. 1.6033-2(g)(1)]. Certain exceptions to the filing requirement are provided for organizations that are included in a group return and churches (and certain ancillary organizations). In addition, certain tax-exempt organizations are prohibited from filing the Form 990-N. Instead, a Form 990 or Form 990-EZ must be filed in the following circumstances:

1. If the organization's annual gross receipts are normally greater than $50,000.
2. By a Section 509(a)(3) supporting organization.
3. By a Section 527 (political) organization.

Note: Private foundations must file Form 990-PF.

An organization that is exempt under IRC Sec. 501(a) and required to file Form 990, 990-EZ, or 990-N will automatically lose its exemption for failing to file the return for three consecutive years [IRC Sec. 6033(j)(1)]. The organization's tax-exempt status will not be revoked until the filing due date of the third year. However, the IRS encourages the submission of Form 990-N (for eligible organizations) even if it is late.

The IRS is now required to notify an organization that has failed to file a Form 990-series return or notice (i.e., e-Postcard) for two consecutive years that the organization is at risk of revocation if it fails to file for a third consecutive year. Not only must the notice indicate that the IRS has no record of receiving a return or postcard from the organization for two consecutive years, the IRS must also inform the organization that its tax-exempt status will be automatically revoked if the organization does not file a return or postcard by the next due date (i.e., by the due date for the third year) [IRC Sec. 6033(j)(1)].

Oops—Gross Receipts Actually Exceeded $50,000

If an organization submits a Form 990-N, despite being unknowingly ineligible (e.g., gross receipts exceeded $50,000), did not file the required return (Form 990, 990-EZ, or 990-PF), and it is discovered in an IRS examination, the organization will be deemed to have not filed. This failure to file can contribute to automatic revocation.

Earlier this year the Chief Counsel, in Legal Advice Memorandum (LAM) 20221101F, addressed what happens when an organization's exempt status is automatically revoked yet it did not receive a nonfiling notice. The LAM notes there are situations (like the one described previously) in which the IRS will have been unaware that the organization had not filed the required returns, therefore would not have previously notified the organization as required under IRC Sec. 6033(j)(1)(A) that there is no record of the organization having filed the required return or notice for two consecutive years.

Required notice and automatic revocation. According to the Chief Counsel, IRC Sec. 6033(j)(1)(B) does not condition automatic revocation of an organization's exempt status on the IRS's issuance, or an organization's receipt, of a nonfiler notice. The organization's failure to file the required return in the third consecutive year is the only condition required for automatic revocation. The LAM noted that while the lack of notice does not excuse an organization from its compliance with its reporting obligations, it could be relevant when determining whether an organization applying for retroactive reinstatement of its exempt status had reasonable cause for its failure to file.

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Note: After an examination in which the IRS determined that an organization improperly filed a Form 990-N for one or two years, the IRS must provide the required nonfiling notice as they cannot argue there was no record of the organization having filed.

Appeal rights. An automatic revocation is not an adverse determination that may be administratively appealed. However, appeal rights can be discretionarily afforded on the issue of gross receipts when the IRS has determined, after an examination, that an organization was not eligible to file Form 990-N because its annual gross receipts normally exceeded $50,000. Appeals would then consider whether the IRS properly determined the organization's gross receipts. If Appeals determines that the gross receipts made it ineligible to submit Form 990-N, the organization would automatically lose its exempt status by operation of law. However, if Appeals reverses the IRS auditor's gross receipts determination, the organization would not automatically lose its exempt status.

Tax Briefs

UKRAINE ELIGIBLE FOR LEAVE BASED DONATIONS. On March 3, 2022, Ukraine was designated Temporary Protected Status and employers may have adopted or be considering adopting employer leave-based donation programs to aid citizens and residents of Ukraine; individuals working, traveling, or currently present in Ukraine; or refugees from Ukraine (i.e., victims). The IRS recently issued a notice providing guidance on the federal income and employment tax treatment of cash payments made by employers under leave-based donation programs to aid victims. The guidance applies to payments made by an employer before January 1, 2023, to Section 170(c) organizations to aid victims. These payments will not be treated as gross income or wages of the employees. Similarly, employees electing to forgo leave that funds the qualified employer leave-based donation payments will not be treated as constructively receiving gross income or wages. It is similar to previous guidance provided in Notice 2001-69, as modified and superseded by Notice 2003-1 regarding charitable relief following the September 11, 2001 terrorist attacks (Notice 2022-28, 2022-23 IRB 1182).

IRS SUSPENDS DELINQUENT RETURN NOTICES FOR EXEMPT ENTITIES. In its Exempt Organization newsletter published March 25, 2022, the IRS announced it will temporarily stop issuing delinquent return notices to tax-exempt entities. The IRS has not been able to process numerous returns because of the COVID-19 pandemic. However, IRS computers have been sending out delinquent return notices to taxpayers who have already filed returns but have not yet been processed by the IRS. To avoid further confusion, the IRS has suspended sending out the following Notices:

- CP 259A, First Taxpayer Delinquency Investigation Notice for Form 990/990EZ/990N.
- CP259B, First Taxpayer Delinquency Investigation Notice for Form 990PF.
- CP259D, First Taxpayer Delinquency Investigation Notice for Form 990T.
- CP259H, First Taxpayer Delinquency Investigation Notice for Form 990/990EZ.