

THE PPC NONPROFIT UPDATE

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Distinguishing Advertising Income from Royalties



Overview

When an exempt organization produces editorial content for its own publication, that activity may be substantially related to the performance of the organization's exempt purpose if the editorial content is related to the organization's exempt purpose. If this is the case, some or all of the income from the sale of the publication is not unrelated business taxable income (UBTI). However, the publication of commercial advertising is generally a trade or business that is not substantially related to the performance of an organization's exempt purpose and, therefore, income from this activity is UBTI. Recall that under IRC Sec. 513(a) producing funds *used* in the exempt activity does not classify the activity as related to the exempt purpose and escape unrelated business income (UBI) treatment. Consequentially, activities such as soliciting, selling, and publishing commercial advertising do not lose identity as unrelated trades or businesses just because the advertisements appear in a publication

that contains editorial material related to the organization's exempt purpose.

Attempting to Reclassify Taxable Advertising Income

Royalties are excluded from UBI under IRC Sec. 512(b)(2). Therefore, organizations can sometimes avoid classifying advertising income as UBI by: (1) directly structuring the advertising itself as royalty income, or (2) transferring the publication rights of the periodical to a publisher in exchange for a royalty.

Qualifying the payments as royalty income. To qualify as a royalty, a payment must relate to the use of a valuable right, such as a trademark, trade name, logo, or copyright. It can be difficult to hold services to the necessary minimum because of a desire to control an activity. If an organization must render more than *de minimis* services as part of the agreement to receive a payment, the income is not royalty income as illustrated by Rev. Rul. 81-178 (1981-2 CB 135). In this ruling,

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the IRS determined that payments an exempt labor organization received under a license agreement that were for the use of trademarks, trade names, service marks, or copyrights were indeed royalties. On the other hand, payments for personal services that required members to endorse products or services in personal appearances and interviews were not royalties.

Planning Strategy: The contract with the publisher should separately charge for: (1) services to be rendered and (2) passive royalties for the use of the organization's intangible assets (e.g., name, logo, and mailing list).

In the publishing scenario, Ltr. Rul. 7926003 illustrates that UBI may be avoided by directly structuring the publication's advertising as royalty income. In the ruling, the exempt business league (League) entered into contract with a publisher (Publisher) to publish a monthly periodical. Publisher bears all production costs and determines the contents of the periodical which is confined to serving League's stated purposes. Publisher pays League specific percentages of any excess of annual gross advertising billing over specified amounts. League supplies the mailing list and holds all copyrights. Publisher also has the right to use the assumed name owned by League. When advertising receipts fall below the amounts specified in the contract, League receives no income. The advertising receipts of Publisher cannot be imputed to League.

Active participation will prevent royalty treatment.

Organizations will often outsource the publishing of periodicals. Income that is generated by an agent will retain its character. Therefore, to avoid treatment as UBI, the publisher must not be functioning as an agent. The income from a magazine or other periodical generally will be taxable UBI when the exempt organization is an active participant in its publication or retains editorial control over the publisher.

In *Fraternal Order of Police* [60 AFTR 2d 87-6050 (7th Cir. 1987)], the organization received income subject to UBTI under an arrangement to sell space for business listings in its magazine. The facts of the case revealed that the organization: controlled the solicitation activity for business listings in the magazine's directory, controlled the program's bank account, shared proceeds from the sales, and generally actively managed the entire activity. Consequently, the Tax Court determined, and the 7th Circuit upheld, the organization was an active participant in the publication of the magazine. Therefore, the income was not eligible for the exclusion from UBI as royalty.

In *Arkansas State Police Association Inc.* [89 AFTR 2d 2002-1274 (8th Cir., 2002)] the association contracted with a publishing company (Publisher) to produce its

magazine. Publisher bore all costs and was responsible for all major publication activities, including selling advertising, printing, and distribution. The association authorized Publisher to use its name and logo in these activities in exchange for a fixed annual fee plus a percentage of magazine advertising proceeds. The association actively participated in the magazine's publication by retaining complete control over the editorial content and collecting and reviewing the materials included in each issue. Consequently, the Tax Court ruled that the income was taxable service income, not royalty income. On appeal, the 8th Circuit held that the income could not qualify as royalty income regardless of the level of the Association's participation in publication activities. The Court stated that a royalty exists only if another entity (e.g., the Publisher) uses an exempt organization's name, logo, or other intangible asset to promote the user's product or services. However, in this instance, the Court concluded that Publisher used the association's name to promote the magazine, not Publisher's business.

Observation: The 8th Circuit's viewpoint seems to be unnecessarily restrictive since the publication of the association's magazine was part of the publisher's business. Nevertheless, exempt organizations in the 8th Circuit or with more than minor level of participation in the publication activities should be prepared for the IRS to consider the advertising revenue UBI.

Practical Consideration:

An exempt organization may be tempted to convert advertising income related to a periodical into royalty income to escape classification as UBTI. However, an organization must carefully follow the established guidance.

IRS Audit Procedures

In a recent Issue Snapshot, the IRS summarizes the guidance relevant to this fact-based determination and indicates steps that an IRS Examiner may undertake if the issue arises. These steps include the following:

- Analyze expenditures for advertising, publications, etc.
- Analyze payments for royalties, commissions, advertising, publications, etc.
- Review contracts and licensing agreements with third-party publishers.
- Review the organization's website.
- Review correspondence between the organization and third-party publishers.

- Interview personnel tasked with advertising and publications.

The Issue Snapshot is available on the IRS's website at www.irs.gov/charities-non-profits/advertising-unrelated-business-taxable-income-and-3rd-party-contractor-issues. For detailed coverage of "Income from Advertising," see Chapter 14 in PPC's *990 Deskbook*.



Limited Liability Company Organizational Standards

No formal guidance has existed addressing the requirements for recognizing a limited liability company (LLC) as an organization described in Section 501(c)(3) since LLC statutes were enacted many years after the Section 501(c)(3) regulations. Historically, for a favorable determination letter to be issued to an LLC, the LLC members were required to be Section 501(c)(3) organizations, governmental units, or wholly-owned instrumentalities of a state or political subdivision. Additionally, nonprecedential guidance from the IRS listed 12 elements that were to be included in the language of the organizing documents.

In the November 2021 edition of this newsletter, the "Priority Guidance Plan for Exempt Organizations" article indicated that the Treasury Department included defining how an LLC can qualify as a Section 501(c)(3) organization in its list of expected guidance—that guidance is contained in Notice 2021-56 (2021-45 IRB 716). Generally, the notice is intended to ensure that the LLC is organized and operated exclusively for exempt purposes and that its assets are used in the exempt purpose and do not provide private benefit.

Note: The notice does not affect the status of organizations currently recognized as exempt under IRC Sec. 501(c)(3).

The new guidance provides that an LLC submitting Form 1023 [Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code] after October 21, 2021 must satisfy the following requirements intended to ensure that the LLC is organization and operated exclusively for exempt

purposes. The articles of organization and the LLC's operating agreement must each include the following:

1. Provisions requiring each member of the LLC be either (a) an exempt Section 501(c)(3) organization, or (b) a Section 170(c)(1) governmental unit (or wholly-owned instrumentality).
2. Express charitable purposes and charitable dissolution provisions in compliance with Reg. 1.501(c)(3)–(1)(b)(1) and (4).
3. An acceptable contingency plan in the event that one or more members cease to be Section 501(c)(3) organization or governmental unit.
4. If the LLC is a private foundation, provisions that comply with Section 508(e)(1).

In addition, the LLC must represent that all provisions in its articles of organization and operating agreement are consistent with applicable state LLC law and are legally enforceable. However, if the state of formation prohibits the addition of provisions to the articles of organization, other than certain provisions specified by the state, the requirement can be satisfied by including the required provisions (listed previously) in the LLC's operating agreement as long as the articles of organization and operating agreement do not include any inconsistent provisions.

The Treasury and IRS are requesting comments about these standards and the need for additional guidance. Several questions are specified in Notice 2021-56. Written comments may be submitted by February 6, 2022 either electronically (recommended due to mail delays) at www.regulations.gov; or by mail to Internal Revenue Service, CC:PA:LPD:PR (Notice 2021-56), Room 5203, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.



Tax Brief

FORM 1023 FAQs RECENTLY REORGANIZED. The IRS's FAQs (www.irs.gov/charities-non-profits/frequently-asked-questions-about-form-1023) can be a helpful resource when completing the complicated Form 1023 [Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code]. The IRS has recently updated the structure of the webpage to make it more user friendly. A complete and accurate originally filed Form 1023 can save an organization much time and delays in obtaining approval. When the application is approved, the IRS will issue a determination letter recognizing the organization's tax-exempt status. For complete guidance on the preparation of Form 1023, see PPC's *990 Deskbook*.



Revenue Disclosures— Reminders for Preparers and Auditors

ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, provides a principles-based framework for recognizing revenue and superseded virtually all revenue guidance for exchange transactions. The overall principle is that an organization recognizes revenue from contracts with customers when it transfers goods or services to the customer at the amount the organization expects to be entitled to receive for the exchange from the customer. FASB ASC 606 introduced a five-step approach to apply when recognizing revenue, and it significantly expanded the required disclosures. One important consideration is that FASB ASC 606 doesn't apply to contributions. Those transactions continue to follow the guidance in FASB ASC 958-605.

As part of our review of financial statements from actual nonprofit organizations while updating our products during the past year, the editors noted that not all nonprofit organizations were making all the required disclosures. Here is a refresher on those disclosure requirements that may be helpful to both nonprofit organizations and their auditors.

Practical Consideration:

PPC's Nonprofit Financial Statement Illustrations and Trends includes financial statements received from firms and nonprofit organizations from all over the country. *PPC's Guide to Nonprofit GAAP* and *PPC's Guide to Preparing Nonprofit Financial Statements* both have detailed discussions of FASB ASC 606's five-step approach. For more information, go to tax.thomsonreuters.com.

Effective Dates

For most nonprofit organizations, ASU 2014-19 was originally effective for years beginning after December 15, 2017 and interim periods within years beginning after December 15, 2018. The issuance of ASU 2015-14 delayed that effective date by one year.

In response to COVID-19, on June 3, 2020, the FASB issued ASU 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, which deferred the effective

date of ASU 2014-09 by one year for private nonprofit organizations that had not yet issued financial statements or made financial statements available for issuance as of June 3, 2020. For those entities, the revenue recognition standards are effective for annual reporting periods beginning after December 15, 2019, and interim reporting periods within annual reporting periods beginning after December 15, 2020. However, the revenue recognition guidance was already effective for nonprofit organizations that are conduit bond obligors before the issuance of ASU 2020-05, and those entities didn't receive a deferral. Entities covered by the deferral weren't required to defer adoption of FASB ASC 606, but could elect to adopt the guidance based on the previous effective date.

After issuing ASU 2014-09, the FASB issued several ASUs to clarify matters related to FASB ASC Topic 606. Those subsequently issued ASUs have the same effective dates as ASU 2014-09.

All deferrals have run out and FASB ASC 606 now applies to all nonprofit organizations.

Disclosure Requirements

FASB ASC 606 significantly increased both quantitative and qualitative information required to be disclosed. The objective of these disclosures is to provide financial statement users with information to understand the nature, amount, timing, and uncertainty of revenues and related cash flows. Each organization should determine the amount of disclosure needed to meet this objective.

Separate disclosure under FASB ASC Topic 606 isn't required if the organization already discloses the information based on other GAAP. In addition, nonprofit organizations may elect not to make certain disclosures. Following is a refresher on the requirements.

The following should be disclosed as of each date for which a statement of financial position is presented and for each period for which a statement of activities is presented:

- Revenue recognized from customer contracts, either on the face of the financial statements or in notes to the financial statements, separately from amounts not associated with customer contracts (FASB ASC 606-10-50-4).
- Impairment (credit) losses recognized for both customer receivables and contract assets, either on the face of the financial statements or in notes to the financial statements (FASB ASC 606-10-50-4).

- Revenue disaggregated based on how control of goods and services transfer to customers, over time or at a point in time (FASB ASC 606-10-50-7).
- Disaggregated revenue by categories that reflect how economic factors (i.e., type of contract, type of customer, geographical location of customers) affect the nature, amount, timing, and uncertainty of revenue and cash flows (FASB ASC 606-10-50-7, FASB ASC 606-10-55-89 through 55-91). Most nonprofit organizations can elect not to make this disclosure but must then disclose this information qualitatively (FASB ASC 606-10-50-7).
- Beginning and ending balances of receivables from customer contracts, contract assets, and contract liabilities (FASB ASC 606-10-50-11).
- Information about contract performance obligations, including the nature of promised goods and services, when performance obligations are generally satisfied, significant payment terms (payment due dates, any variable consideration, any significant financing component), any related obligations for returns or refunds, and any warranty obligations (FASB ASC 606-10-50-12 and -12A).
- Significant judgments and changes in significant judgments affecting amounts and timing of revenue recognized, including those used to determine both the timing of satisfying performance obligations, and the transaction price and amounts allocated to performance obligations (FASB ASC 606-10-50-17).
- Transition disclosures which vary based on whether the organization used the full retrospective or modified retrospective approach (FASB ASC 606-10-65-1).

Practical Consideration:

FASB ASC Topic 606-10-55 includes implementation guidance on how to apply the Topic to contracts with customers and illustrations of disclosures. FASB Topic ASC 606 is available at www.fasb.org and at www.checkpoint.riag.com. Also, *PPC's Interactive Disclosure Library for Nonprofit Organizations* includes both an electronic version of our financial statement disclosure checklist for nonprofit organizations and examples illustrating the required disclosures. Go to tax.thomsonreuters.com for more information.



FASB Not-for-Profit Advisory Committee Activities

The FASB's Not-for-Profit Advisory Committee (NAC) works with the FASB to provide input on the impact of accounting standards on the nonprofit sector. The NAC usually meets twice a year. NAC met on September 14, 2021. Here are highlights of that meeting.

Practical Consideration:

Information about NAC activities and meeting minutes are available at www.fasb.org.

FASB ASC 606 Post-implementation Review

The FASB staff asked NAC members for feedback about their implementation experience with FASB ASC 606, *Revenue from Contracts with Customers*, including costs and benefits experienced in practice and the post-implementation review plan for nonprofit entities. NAC members noted that some nonprofit entities are still in the process of implementing the standard because of the optional one-year deferral the FASB granted last year. They noted the standard was not difficult to implement and that educational resources provided by the FASB and AICPA were helpful. Committee members said the costs were manageable, and many nonprofit entities without public debt elected the disclosure exemptions available. In most cases there were no significant changes noted in amounts of revenue recognized under FASB ASC 606.

ASU 2018-08 Post-implementation Discussion

This was the NAC's initial post-implementation discussion about ASU 2018-08, *Not-for-Profit Entities (Topic 958): Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made*. The Committee provided feedback to the FASB Board and staff members about their experiences implementing the standard and the costs and benefits experienced in practice.

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NAC members had positive comments about implementation. They noted the practical examples and flowcharts in ASU 2018-08 and FASB Staff Q&A, *Subtopic 958-605*, were helpful. Strong communications between nonprofit entities, grantors, and auditors aided implementation. The implementation costs were generally as expected, although certain one-time system changes were necessary.

The Committee members agreed that this ASU provided timely guidance needed to account for COVID-19 assistance. Implementation issues that arose resulted more from uncertainty about grant terms and changing guidance from the federal agencies than from applying the standard to the grants. NAC noted diversity in disclosures as a result of the principles-based approach and no requirement to disclosure policies for evaluating barriers to entitlement. However, NAC did not recommend any specific changes to FASB ASC 958-605 at this time.

Gifts-in-Kind Reporting Update

The FASB staff provided an update on questions they received at recent conferences and webcasts about ASU 2020-07, *Not-for-Profit Entities (Topic 958): Presentation and Disclosures by Not-for-Profit Entities for Contributed Nonfinancial Assets*. The NAC discussed that implementation questions result mainly from a general misunderstanding of the definition of nonfinancial assets, but the standard is easily understood.

COVID-19-Related Financial Reporting Issues

The NAC formed a COVID-19 subcommittee that meets with the FASB to discuss accounting and reporting issues related to various Coronavirus Aid, Relief, and Economic Security (CARES) Act programs. The NAC discussed ongoing challenges with reporting related to the Health Care Provider Relief Fund and the AICPA's upcoming release of a Technical Question and Answer (TQA) document on the accounting for donated medical supplies and pharmaceuticals. This document may be helpful in deciding whether to accounting for COVID vaccines supplied by the federal government as in-kind revenues or agency transactions.

Other Items

The FASB staff and the NAC discussed other FASB projects in process, including (1) the FASB's 2021 agenda consultation, (2) identifiable intangible assets and subsequent accounting for goodwill, (3) conceptual framework-elements project, and (4) disclosure framework-interim disclosures. The FASB staff provided updates about their monitoring of implementation of FASB ASC 842, *Leases*, and FASB ASC 848, *Reference Rate Reform*, and related standard-setting activities related to leases since the most recent NAC meeting in March.

