Nonprofit Observer

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Employee Retention Credit update

What you need to know about ERC processing

The federal Employee Retention Credit (ERC) was created by the IRS during the COVID-19 pandemic. It seemed to offer a lifeline to many nonprofits struggling to keep employees on board and their organizations afloat. But for some employers, it may just have been too good to be true. Read on to learn about possible abuses on the part of some employers and the IRS's response.

Bumpy road

Shady promoters have led many employers astray, promising big payouts if they claimed the ERC (and demanding significant fees for the tax "assistance"). But some of these employers weren't actually eligible for the credit. Requirements are stringent, despite what some promoters have claimed.

Promoters that told employers they had "nothing to lose" in filing a claim were incorrect, according to the IRS. In reality, organizations could run into repayment requirements, penalties, interest and audits. This has led to dramatic delays in ERC claims processing and the IRS has taken several steps to deal with invalid claims.

Straight and narrow

The ERC is a refundable tax credit targeted at employers that:

1. Continued paying their employees when they were shut down due to the pandemic in 2020 or 2021, or
2. Suffered significant drops in gross receipts from March 13, 2020, to December 31, 2021.

The ERC Withdrawal Program is available to eligible employers that filed a claim but haven't received, cashed or deposited a refund.

The maximum per-employee credit was $5,000 for 2020. It rose to $7,000 per quarter for the first three quarters of 2021, meaning employers could potentially receive refunds of as much as $26,000 for each retained employee.

In September 2023, after a flood of invalid claims, the IRS halted processing new claims submitted after September 14, 2023. The agency used the hiatus to review about one million ERC claims representing more than $86 million. It found that 10% to 20% of the claims had clear signs of being erroneous, and another 60% to 70% demonstrated an unacceptable level of risk. The IRS announced that tens of thousands of the erroneous claims would be denied and that those with unacceptable risk would undergo further analysis. By August 2024, the agency had sent 28,000 disallowance

letters to employers whose claims showed a high risk of being incorrect.

By the numbers

The IRS's review of 2020 claims revealed more than 22,000 improper claims, resulting in $572 million in assessments against employers. These numbers could climb when the agency reviews 2021 claims, as the maximum per-employee credit that year was $21,000.

As of June 2024, more than 1.4 million ERC claims remained unprocessed, as the IRS closely examined them. In early August 2024, though, the IRS announced that it had identified 50,000 valid ERC claims and was moving them forward for payment processing. Payments were to begin in September, with additional payments going out in subsequent weeks. Another large block of low-risk claims was slated for processing and payment in the fall.

Your road map

Many nonprofits may now wonder if their ERC claims can withstand IRS scrutiny. If you're among them, you have some options to reduce your risk. For example, if your organization overclaimed the ERC, you can amend your return to correct the amount.

If you haven't yet received the ERC payout, you also can take advantage of the ERC Withdrawal Program. It's available to eligible employers that filed a claim but haven't received, cashed or deposited a refund. Your organization is eligible if it:

- Made the claim on an adjusted employment tax return (Forms 941-X, 943-X, 944-X, CT-1X),
- Filed the adjusted return solely to claim the ERC, with no other adjustment, and
- Seeks to withdraw the entire amount of its ERC claim.

The IRS has stated that it will treat withdrawn claims as if they had never been filed, and no interest or penalties will apply.

Don't go it alone

While news about the ERC has been coming out at a steady pace over the past 18 months, one thing has remained the same: The IRS continues to encourage employers to work with trusted tax professionals who understand the ERC's complex rules. We're here to help you navigate recent developments and chart the right course.

RED FLAGS FOR INVALID ERC CLAIMS

The IRS has identified several warning signs it's seen on incorrect Employee Retention Credit (ERC) claims. For example, employers that could fully operate and didn't suffer a drop in gross receipts weren't eligible for the ERC. Note that modifications that didn't affect an employer's ability to operate, such as requiring employees to wash hands or wear masks, don't mean the business operations were suspended.

The IRS has also found invalid claims where employers:

- Can't support how a government order fully or partially suspended their operations,
- Claim the ERC on wages that they reported as payroll costs to obtain Paycheck Protection Program loan forgiveness,
- Claim the credit for too many quarters or for every employee on their payroll,
- Base their claims on supply chain disruptions, and
- Didn't pay wages or weren't in operation during the eligibility periods.

The agency also has reminded employers that they may receive payments for some valid tax periods, while it reviews other periods for eligibility. Remember, ERC eligibility can vary from one tax period to another if, for example, government orders were rolled back.

Investment policies are more important than ever

The past five years have been turbulent for many nonprofits. The fallout from the pandemic, inflation and other uncertainties have undermined their financial health and left some struggling to survive. A solid investment policy can help your organization weather such times more successfully.

Understanding investment policies

An investment policy is a blueprint for how to manage a nonprofit's investments in light of its long-term goals and objectives. It delegates roles and responsibilities among board members, the investment committee (if applicable), staff, custodians and advisors. Effective investment policies are comprehensive but not overly complex. They lay out clear and understandable guidelines that are easily executed. In addition, they reduce the risk that nonprofit leaders will make ad hoc and unsystematic decisions in the heat of the moment.

Investment policies also help keep your investment strategies on track regardless of the market situation. As leadership evolves, they provide consistency that helps board members satisfy their fiduciary duties. Finally, they offer stakeholders reassurances about the organization's financial stewardship and sustainability.

Getting started

When drafting an investment policy, your nonprofit must consider a wide range of factors, including the following:

Purpose. What is the purpose of the investments? Identify both short- and long-term purposes, such as predictable payouts, capital preservation, long-term growth and specific return on investment. If you have multiple investment portfolios, identify the purposes for each.

Investment target. Based on the purpose, you can set a target for your investment returns (including any management or administrative fees). Remember, too, to account for long-term inflation. Previously, it was reasonable to use a 2% to 3% figure for inflation, but you may want to raise this rate in light of recent inflation trends, and even to account for how factors such as climate change might affect prices in the not-so-distant future.

Risk appetite. How much risk is your nonprofit willing to accept to achieve its mission and objectives, bearing in mind the amounts required to sustain daily operations? This determination is based on:

- Your organization's comfort level with short-term losses and volatility,
- The degree of diversification you desire,

- Any applicable regulations and restrictions,
- Required liquidity levels, and
- Time horizons.

Risk appetite generally is something that warrants discussion among the full board.

Investment choices. Nonprofits often have preferences about the types of investments they wish to pursue. For example, it's increasingly common to take environmental, social and governance (ESG) considerations into account. Similarly, you may want to prohibit some investments. An environmental nonprofit, for instance, might want to avoid buying fossil fuel stocks. But prohibited investments should be defined narrowly so you don't unintentionally handcuff your investment advisors.

Asset allocation. Your nonprofit's investment portfolio generally should include a variety of asset classes, including equities (international and U.S.), fixed income (such as bonds and certificates of deposit), real estate, commodities, and private equity. Make sure your investment policy establishes target allocations for each asset class, as well as an acceptable range. Your policy also should include a rebalancing policy for when a class's portfolio percentage goes above or below the acceptable range. How often will your organization check allocations and what amount of variance will trigger rebalancing?

Performance evaluation. Explain how you'll objectively measure your portfolio's performance. Set an overall portfolio benchmark based on asset allocation targets, along with separate benchmarks for individual asset classes and investments.

Living document

Developing an investment policy isn't a one-off exercise. Your policy requires regular updating to reflect changes to your organization, the investing landscape and other factors. On the other hand, you want to avoid constant tweaking, as an investment policy is intended to provide a steady hand. In most circumstances, an annual review will strike the right balance. ●

Do the right thing

Board member fiduciary duties in a nutshell

Service on a nonprofit board can strike some as a cushy gig that looks good on a resume. The reality can prove much more demanding. Board members are considered fiduciaries, or trustees, and they're legally bound to make decisions they believe will benefit their organizations.

Such legal duties aren't only important for the success of nonprofits. Compliance also can protect board members from liability, assuming their decisions are made in good faith. Here's how your board members can help ensure they're fulfilling their obligations.

Duty of care

Board members must devote reasonable care and attention to provide the requisite oversight of your nonprofit. Among other things, they must ensure

the prudent use of all assets including funds, facilities, staff and goodwill. This means that they need to be familiar with your organization's financial status. It's not enough to know whether your group has a budget surplus or deficit — members should know how to read and interpret budgets, financial statements and other critical documents.

Duty of care also requires members to attend most meetings (if not in person then at least virtually) and read reports. And they must exercise sound judgment when making decisions, accounting for all relevant information rather than simply accepting staff recommendations.

Duty of loyalty

Members are obligated to act in the best interests of your nonprofit and its stakeholders. They should see to it that all of their activities and financial transactions are designed solely to advance your organization's mission, not their own interests.

The duty of loyalty requires your board to identify and disclose all conflicts of interest. Board members also should abstain from discussions or votes on matters that could benefit them or people close to them.

For example, a member should disclose that he or she holds an ownership interest in a vendor business under consideration for a contract. Such a contract could constitute inappropriate self-dealing and provide an "excess benefit." That could happen if your nonprofit paid more for the service than another customer would — or more than you'd pay a different vendor for the same service.

Duty of obedience

This duty relates to legal compliance. Board members must confirm that your organization follows all applicable federal and state laws, rules and regulations, as well as its own bylaws and other governing documents.

Board members also should confirm that your nonprofit files all required federal and state information and tax returns. And to avoid revocation of your organization's status, they should ensure that it abides by its purpose of activities (or mission).

Other duties

Of course, board members also have more routine responsibilities. New members, for example, might not realize that they're expected to evaluate and set your organization's executive director's salary. Or they might not know how actively they're expected to participate in fundraising.

In contrast to members who might underestimate their responsibilities, some board members could believe their duties are far broader than they are or should be. Although they should contribute to fundraising, strategic planning and oversight, the board largely needs to stay out of your organization's day-to-day operations. Board members may collaborate with paid staff, but it's up to your executive director to manage these employees.

Getting it right

Solid board leadership is essential. Nonprofit board members often are recruited based on their passion for the cause. Unfortunately, passion alone doesn't guarantee effective board performance. Help your members succeed by properly educating them on their roles and responsibilities.

Are you valuing tangible property correctly?

Both new and established nonprofit organizations may not know how to value tangible property donations if they don't receive them very often. Here's a quick overview to help you review the rules.

Defining FMV

Most tangible property donated to a charitable organization is valued based on fair market value (FMV) — generally, the price that the property would sell for on the open market. If a donor contributes used clothes for a charity to distribute to refugees, the FMV would be the price that typical buyers pay for clothes of the same age, condition, style and use.

If the donated property is subject to any type of restriction on use, the FMV must reflect it. So, if a donor stipulates that a painting must be displayed, not sold, that restriction affects its value.

What to consider

There are three particularly relevant FMV factors:

1. Cost or selling price. This is the amount the donor paid for the item or the selling price received by your organization on disposal. Because market conditions can change, that cost or sales price becomes less important the further in time the purchase or sale is from the contribution date.

2. Comparable sales. This is the sales price of property similar to the donated property. The IRS may give more or less weight to a comparable sale depending on the:

- Similarity between the property sold and the donated property,
- Time of the sale,
- Circumstances of the sale, and
- General market conditions.

3. Replacement cost. FMV should consider the cost of buying or creating property similar to the donated item. However, the replacement cost must have a reasonable relationship with the FMV.

Receiving real estate

Restrictions on the use of real estate can dramatically affect the value of such gifts. For example, land that isn't eligible for commercial development often is considered less valuable than land that is. If your organization rents a space free of charge, or at below FMV, you must record an in-kind contribution. This is estimated at the fair rent, or the difference between the fair rent and the below-market rent that you're paying.

In a multi-year lease, the lease's FMV can't exceed the property's FMV. For example, if your total lease payments equal $3 million, where the property's FMV is $2.5 million, the contribution recorded in the first year would be limited to $2.5 million.

Critical value

Properly valuing tangible property donations is critical for preparing accurate financial statements. In addition, you'll be reporting these valued property donations to the IRS in various parts of your annual information return. Note that with certain large donations of tangible property, the *donor* is required to meet additional IRS requirements regarding value to claim a tax deduction. Contact us if you need help valuing large donations.

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