10 Nonprofit Tax Issues to Address Before an IRS Audit

Knowing what examiners look for can help your organization prepare.

While the percentage of nonprofit tax returns examined by the IRS has slipped back to pre-2010 levels, it remains higher than the rates for small corporations and individuals. The frequency is still high enough that it strikes fear into the hearts of many who are responsible for annual tax filings.

The good news is that IRS examination patterns can serve as a guide for tax-exempt organizations wishing to avoid the excise taxes, penalties, and other consequences of noncompliance. Preparation is the best answer to an audit notice.

Following are 10 areas of concern that often come up in IRS examinations of nonprofits.

1) Executive officer compensation

The IRS may determine that your organization's executive compensation is an "excess benefit transaction." In essence, the IRS is claiming that an individual's total compensation package, including all benefits, is greater than the value of the work the person performs. Unless the claim is proven wrong, the individual is subject to a 25 percent excise tax, and the managers who approved the compensation are subject to a 10 percent excise tax up to $20,000.

The burden of proof is generally on the organization, which must prove that the compensation is not excessive. However, if you follow three steps called the "rebuttable presumption of reasonableness," the burden of proof shifts to the IRS.

Surprise and panic are your worst enemies when an IRS audit notice arrives. Preparation can be your best friend, but you have to know what to expect.

1. Review and approval by an independent governing body or compensation committee
2. Use of comparable compensation data for similarly qualified persons in equivalent positions at similar organizations
3. Documentation and recordkeeping of the deliberations and decisions

If the IRS attempts to develop sufficient contrary evidence to rebut the presumption of reasonableness, it usually attacks the comparability data or the documentation.

Use competitor tax returns to support your compensation decisions

The instructions to Form 990 Schedule J state that organizations may use the tax returns of similar organizations to determine comparable compensation. IRS guidance also suggests that small organizations (those averaging less than $1 million in gross revenue) may rely on as few as three comparable organizations for such data. This implies, of course, that larger organizations should have a more rigorous method than simply downloading Form 990 from three similar nonprofit organizations.

When considering whether to penalize for excessive compensation, the IRS looks at the following factors:

- Is the comparability data for a similar function at a similar organization (taxable or tax-exempt)?
- Are similar services available in the local geographic area?
- Did the organization obtain a compensation survey from a reputable professional firm with industry knowledge and expertise?
- Does the individual have written employment offers from similar organizations?

Organizations under these circumstances should engage an outside, independent professional to perform an annual compensation survey. Nonprofit compensation data may also be obtained from the Council on Foundations and the *Guidestar Nonprofit Compensation Report*.

2) Form 1099 for independent contractors

Every vendor you pay can be scrutinized for classification and reporting compliance. The IRS will go through your general ledger and ask for copies of contracts, receipts, invoices, and Forms 1099. If the IRS determines that your organization should have sent a 1099 to a vendor but failed to do so, it can impose a $100 "failure to file" penalty and an additional $100 "failure to furnish" penalty for each occurrence. Those amounts are set to increase for information returns filed after December 31, 2015.

The IRS can also require you to submit evidence for specified vendors for subsequent years without opening those years up to a full examination. For example, if the IRS is examining the 2012 tax return and determines that the 1099 reporting requirements were not met in 2012, it does not have to formally open an examination of subsequent year tax returns in order to demand evidence that the organization met its 1099 reporting requirements in those years.

If your organization fails to issue a required 1099, the IRS will allow you to contact the vendor for confirmation that the vendor did, in fact, report the payment on its own tax return. If you don't receive confirmation, you could be subject to a 28 percent backup withholding tax. For example, if you fail to issue a required 1099 to a vendor that was paid $20,000, you may be liable for $5,600 in backup withholding tax, plus penalties and interest.

Make it a habit: Obtain a W-9 from all vendors

Obtain a Form W-9, Request for Taxpayer Identification Number and Certification, from every vendor you do business with for every single year there is a transaction. If the IRS determines that the organization failed to file a required Form 1099 but did obtain a contemporaneous W-9, the IRS will impose the failure to file/furnish penalties, but it cannot impose the 28 percent backup withholding tax.

You should also have a robust system for issuing Form 1099. It is easy to overlook certain vendors, to mistakenly assume that a vendor is a corporation, or to rely on conclusions reached in prior years. At the end of every year, do a thorough and critical analysis of all vendors who received at least $600 during the year. If in doubt, it is usually better to issue a 1099 that wasn't necessary than to overlook one that was required.

3) Value of gifts to employees

Your organization gave Henry a $500 gift for his 25th anniversary and didn't include the amount on his W-2. You also gave your employees a $50 gift card for dinner and a movie, but didn't report it as taxable compensation. You are liable for both the employer and the employee portion of payroll taxes, as well as 25 percent federal income tax.

Include the value of gifts in employee compensation

Cash and gift certificates must always be included in taxable income. Other gifts must also generally be included unless they are "de minimis," meaning that they are so small that accounting for them is impractical or unreasonable. Examples of de minimis benefits that do not need to be treated as taxable income include:

- Occasional use of the office copier and other supplies
- Snacks, coffee, doughnuts
- Occasional tickets to entertainment
- Flowers or fruit baskets for special circumstances
- Personal use of cell phone or laptop provided primarily for business

Business expenses that are reimbursed under an accountable plan are not taxable compensation.

When in doubt, it is better to include the amount in taxable compensation. You may choose to "gross-up" the payment to achieve the desired after-tax consequences. For example, if you really want Henry to get $500, pay him $650.

4) Advertising and sponsorships

Your organization has "sponsors" who receive acknowledgement, either on your website, as part of a conference or trade show, or as part of contractual fee-for-services arrangement. While the entire payment may be classified as "sponsorship income" on your financial statements, the IRS will attempt to break these payments down into their constituent parts. Some parts of the payment may be excludible as a contribution, as exempt function income, or as a royalty. The examiner will attempt to determine if any portion of the acknowledgement is taxable as advertising.

Know the difference between advertising and sponsorships and treat the income differently

To start, you must understand the distinction between acknowledging a sponsor (nontaxable) and advertising (taxable). Advertising is a payment from an outsider in which the outsider receives something of benefit in return.

An advertisement:

- Promotes or encourages the use of the trade, business, service, facility, or product of the payor ("Visit today and check out our fine selection of tires")
- Contains qualitative or comparative language ("Offering the finest selection of tires in town" or "The largest selection of tires in town")
- Offers an endorsement ("Recommended for all your automotive needs")
- Provides price information or indications of savings or value ("Home of the 'Buy 3 Get 1 Free' Special" or "Show your ticket stub for a 10% discount")

In most cases, advertising revenue will be treated as unrelated business income (UBI) subject to taxation, unless the activity is not regularly carried on, or if it is directly related to the accomplishment of the exempt purpose of your organization (for example, a student newspaper, where selling ads is part of the training).

A sponsorship is a payment from an outsider where the payor receives nothing of value in return. The sponsorship acknowledgement may include:

- Recognition as a sponsor, including "exclusive" sponsorship
- Name, address, phone number
- Website
- Logo
- General description of product or services ("Retailer of bathroom fixtures")
- Visual depictions of products or services
- Taglines ("The Ultimate Driving Machine")
- Display or distribution of products

A sponsorship payment is usually treated as contribution revenue. You should provide a written acknowledgement to sponsors who give at least $250. The acknowledgment should specify the value of any benefits that were provided to the donor in connection with the payment, including event tickets, goods, services, and advertising. Benefits other than advertising may be disregarded if the value is less than 2 percent of the sponsorship payment. In the case of qualified convention and trade show activities, benefits other than advertising will not be treated as UBI even if the activity would generate UBI if it were being conducted outside of a convention or trade show.

5) Mailing lists

If you rent your mailing list to outside organizations, the payment is taxable if you provide services in connection with the rental. Some IRS agents take the position that only transactions between two charitable 501(c)(3) organizations can be excluded as royalties, while others have concluded that the activity can only be passive if it is conducted by a third-party list broker.

Use a list broker whenever possible if you rent your mailing list to outside organizations

If you prefer to handle the mailing list rental directly, the agreement should explicitly state that:

- Your organization is not obliged to perform any services (such as sending emails to your members or filtering the data in the list)
- The agreement is not a joint venture or a partnership
- Payment to your organization is for use of the list, and you will not share in the net profit or loss (this does not necessarily preclude the payment of a commission)
- Neither party is acting as an agent for the other
- If the contract contemplates more than just the rental of the mailing list, the portion of the payment that relates to the mailing list should be clearly stated.

6) Lobbying and political activity

Nonprofit organizations have varying restrictions on the amount of lobbying and political activity they are allowed. Engaging in impermissible activities can result in excise taxes or revocation of your exempt status. Membership organizations must notify their donors of the nondeductible portion of dues that is attributable to lobbying, or they must pay a proxy tax.

Understand the difference between lobbying and political activity

You should begin with an understanding of what lobbying and political intervention mean for tax purposes:

- Lobbying is the attempt to influence the passage or defeat of a piece of legislation
  - Direct lobbying is contact with legislators
  - Grassroots lobbying is a call to action to motivate others to contact legislators
- Political intervention is an attempt to influence an election or defeat a candidate
- Lobbying and political intervention do not include:
  - Nonpartisan analysis, study, or research
  - Examination of broad social or economic problems
  - Providing technical advice in response to a written request by a legislative body
  - Communications designed to defend your existence or tax-exempt status

Next, determine the limits applicable to your organization:

- Private foundations may not do any lobbying or political intervention
- Public charities (501(c)(3) organizations) may do limited lobbying but no political intervention
- Non-charitable tax-exempt organizations may lobby and engage in political intervention as long as it is not the "primary purpose" of the organization

You must carefully track expenses related to your lobbying and political activities using one of the IRS's approved methods of accounting:

- Gross-up method
- Ratio method

7) Reporting foreign investments

You may be generally familiar with the reporting requirements related to programs, activities, and grants awarded outside the United States. But it is often more difficult to identify foreign investments that require disclosure on Form 990 Schedule F and on other returns. There are significant penalties for failure to properly disclose foreign investments using the required form.

Your organization may have disclosure and additional filing requirements when:

- It owns an interest in, or transfers property to, a foreign corporation
- It has an interest in a foreign trust
- It owns an interest in a foreign partnership
- It is a direct or indirect shareholder in a passive foreign investment company (PFIC)
- It had operations in a boycotting country
- It has a financial interest or signature authority over a foreign financial account

Track the location of all foreign investments

You can generally avoid problems with foreign investments by tracking the location of all of your organization's investments, including those disclosed in the footnotes in all Schedules K-1 showing pass-through income.

Identify investments that meet the definition of a financial account — A financial account includes, but is not limited to, a securities, brokerage, savings, demand, checking, deposit, time deposit, or other account maintained with a financial institution (or other person performing the services of a financial institution). A financial account also includes a commodity futures or options account, an insurance policy with a cash value (such as a whole life insurance policy), an annuity policy with a cash value, and shares in a mutual fund or similar pooled fund that is available to the general public with a regular net asset value determination and regular redemptions.

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Offshore hedge funds and private equity funds that are not offered to the public will not be considered financial accounts reportable as a financial interest in a foreign account. Owners of offshore private investment fund interest, and individuals with signature authority over these interests, are not required to report these interests unless the private investment fund itself owns financial accounts.

Determine whether the investment in a financial account constitutes a financial interest — A U.S. organization has a financial interest in a foreign financial account for which it is the direct owner of record or holder of legal title, or, among other things, it owns more than 50 percent of a financial account that is located outside the United States.

Identify any foreign investments held indirectly through ownership of a pass-through interest in the United States — Disclosure of such investments is not subject to reporting on Schedule F Part I or for FinCen (FBAR), but may trigger the filing of certain other returns.

Identify foreign investments that are traded on a U.S. stock exchange — These do not need to be reported.

8) Fundraising events

Special events are often unrelated to your exempt purpose. Absent a charitable element, they can be considered UBI, especially if they occur frequently. Nonprofits that conduct lavish events that result in little or no charitable revenue may open themselves to additional scrutiny by the IRS and criticism from the public.

"Donors" at these events must be given written acknowledgement, particularly when they receive something in return, such as an incentive gift. Non-charitable exempt organizations should be very clear that no part of the donation is a charitable donation. Failure to provide the required documentation can cause the donor's charitable donation deduction to be denied, and can subject the nonprofit to penalties.

Accounting for a special event requires that you track the total gross receipts, the fair market value of anything the donor received in return, and the total expenses of the event. Organizations may be tempted to equate the expenses incurred in holding the event with the value received by the donors, but these are two independent calculations. Likewise, do not equate the *value* of any goods or services the donor received with your organization's *cost* of providing those goods and services.

Gaming activities, including lotteries, raffles, casino nights, and poker tournaments, are generally UBI. Most states have strict requirements for licensing and reporting.

Determine a fair market value for the activity; any excess payment is a donation

Careful planning well in advance of the event is essential. Identify the fair market value of the activity, such as attending a dinner or concert, or playing a round of golf. Only the portion of the payment in excess of that fair market value is a charitable donation. Keep careful records of the expenses directly connected to the event.

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For charitable contributions of $250 or more that provide no benefits to the donor, you must provide a written acknowledgement that explicitly states that no goods and services were provided:

- "No goods or services were provided in return for the contribution."

For payments of $75 or more that are partially a contribution and partially a payment for goods and services, you must provide a written acknowledgement that contains a description and good faith estimate of the value of goods and services provided.

- "Thank you for your payment of $100. You received goods and services with a fair market value of $60."

If your organization is exempt under 501(c)(3), you should also state that the deductible portion of the contribution is limited to excess payment over the fair market value of the goods and services received.

With the exception of bingo and non-wagering sweepstakes, organizations should exercise extreme caution if conducting any gaming activity. Be sure to obtain the necessary licenses from local authorities, and comply with all reporting requirements, including Form 990 Schedule G and Form 990-T.

9) Governance policies and fraud

Form 990 Part VI contains numerous "trigger" questions regarding governance policies. With a few exceptions, it is unlikely that the answer to any single question will cause an IRS audit. However, the IRS has concluded that a pattern of weak oversight is an indication that an examination is warranted.

One question that has been known to trigger an IRS audit is regarding "a significant diversion of the organization's assets." An organization that discovers fraud may be tempted to minimize or obscure it for a variety of reasons, not the least of which is the increased chance of an IRS audit.

The entire board should have the opportunity to review Form 990 before it is filed.

Engage your board, educate your employees, and disclose instances of fraud

Your board of directors should be actively engaged in fraud oversight. The board should adopt customized policies that meet your circumstances, including policies for conflict of interest, whistleblower protection, and document retention and destruction. The entire board should have the opportunity to review Form 990 before it is filed. Explanations in Form 990 Schedule O should be brief, concise, and accurate.

Even more important than having a fraud policy is educating managers and employees and monitoring compliance with the policies. Policies should be well publicized, and employees should provide an annual acknowledgement that they have read and understand them. Interested persons should complete an annual disclosure form to identify business and family relationships.

If you become aware of fraud, you must disclose the information on the return for the year of discovery, even if the fraud itself occurred in a prior year. The explanation must include a description of the fraud, the amount involved, and the corrective action taken. Do not provide information that could disclose the identity of the person or persons involved.

10) Respond to IRS compliance notices

Your organization may receive a notice from the IRS but not fully understand its implications, and either disregard it, or fail to bring it to the attention of qualified personnel. Failing to respond, or responding incompletely, can significantly increase the chance of an IRS audit.

Formally designate someone to receive and respond to IRS notices

Form 990 Part VI allows you to provide contact information for "the person who possesses the books and records of the organization." Do not simply fill in the name of your organization. When the IRS initiates contact, it usually does so by mail, not by phone, so it is important that you provide the name of a person who is authorized to respond to these communications. Do not allow notices to languish in the mail room or on the receptionist's desk simply because there is uncertainty about who is responsible for replying.

Promptly notify your tax advisor, even if you intend to respond to the notice without assistance. Do not wait until the day the response is due, or until you receive a second (invariably more threatening) notice to ask for guidance. Engage a professional to prepare or review the response before it is submitted. Making a small investment to ensure a complete and accurate response can save an enormous amount of time and energy later.

How we can help

If you understand what is required for IRS compliance and you act accordingly, there is no need to live in fear of an examination. Preparation begins, not when the examination notice arrives, but in the years prior to receiving it. Our nonprofit consultants can provide guidance, resources, and a tremendous amount of experience, so you can feel confident that your operational practices can stand up to IRS scrutiny.

Author

David Trimner, Principal, Nonprofit Tax
david.trimner@CLAconnect.com or 571-227-9676

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