CPA Practice Advisor

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As the Internal Revenue Service Exempt Organization division twists and turns in the wind over the recent scandal involving undue scrutiny on certain tax-exempt applications, nonprofit managers and practitioners might wonder how this will impact them.

While the future is uncertain for this IRS division, what is certain is they will likely

review, and the examination could be focused on other less visible areas of risk such as the determination of compensation or whether there is any impermissible private benefit.

Here are five areas of risk that the Service is looking at:

- **Fundraising Expenses.** Getting this allocation wrong is a big red flag. The exempt sector has long understood the importance of properly allocating functional expenses. Certainly the general public reviews the ratio of fundraising or general and administrative expenses to total expenses as a way to determine organizational efficacy. The IRS selected about 170 small exempt organizations with high fundraising to program expense ratios for examination in recent years. They are scaling this operation up and applying it to larger nonprofits in the coming years. Conversely, allocating very low or no fundraising expenses while also reporting significant contribution income is also a trigger.
- **Compensation Competence.** This is the big money maker for the Service. Every dollar they allocate to enforcing compensation compliance creates multiples more in tax revenue. There is an army of agents looking over automatically generated 'discrepancies' that indicate potential misclassifications of employees, underreporting of wages, and underpayment of taxes. Whether or not nonprofits have classified workers as independent contractors or employees correctly continues to be of paramount interest to the Service. Also being examined is whether W-9's and W-4's are being used and retained properly, and whether the information entered on to 1099's is consistent between name and EIN.
- **UBI Expense Allocation.** Of particular interest to the Service are nonprofits showing losses in activities year after year that don't appear to have a profit motive and using them to offset gains. Nonprofits have become exceedingly savvy at allocating all sorts of cost to offset taxable activities, and therefore reduce taxable liabilities. This is contrasted against the fact nonprofits are more involved

than ever before with unrelated business activities earning taxable income, such as

on these types of transactions.

- **Political Activity.** Depending on what type of 501(c) organization you are, intervening in the political process in some way might play a vital role in accomplishing your exempt purpose. Whether you are a political 527 organization or a 501(c) (3) just trying to advocate on a specific issue, the Service knows that more and more political activism is coming from the exempt sector. Every election cycle shows higher levels of contributions being directed to nonprofits for political purposes and more money being spent on ads than ever before. In response, the Service has identified and examined around 300 cases of nonprofits with potential related violations. One way the Service identifies potential noncompliance is through referral from outside parties, usually state regulators.

So how do we address these risks effectively?

1) **Expense allocation.** Reacquaint yourself with the functional expense allocation and the underlying methodology. About a third of the examinations performed in this area resulted in fundraising ratios being lowered. Analyze whether the appropriate amount of time and expense is being allocated to fundraising, and if joint costs are being incurred, reassess the split between program and fundraising. Consider whether methodology is consistent from year to year, and whether it is explainable or at least documented properly. Also check with examples of reasonable allocation in the IRS instructions to the Form 990.

2) **Disclosure education.** Education regarding disclosure requirements and the general rules of the road for political activity will go a long way. Understand the difference between issue advocacy and political electioneering. Learn the trigger words that exist in the communication that may tilt it towards being political electioneering, and know the timing of the communication also plays a role in that determination. Be sure your organization is properly registered with the Federal

Election Committee and/or the IRS to conduct political activities. For 501(c)(3)'s,

relationship should be mandatory. Getting updated W-4's annually is also highly recommended.

4) **Profit Motive.** In a recent study by the Service, nearly 70% of nonprofit schools examined reported losses from activities for multiple consecutive years. This will likely result in failure for the activity to qualify as a trade or business, as the Service will assert there is a lack of profit motive. If you have such activities, now would be the time to assess whether the Service would disallow the deduction against other taxable activities. If you have a Net Operating Loss carryforward from multiple years of losses including this activity, consider whether this carryforward is valid.

5) **Confirm UBI.** If your nonprofit organization is part of a controlled group of entities, and there are agreements, contracts, loans or other similar activity between them, attention should be paid to whether UBI is being created. Look for instances of interest, dividends, royalties, and rents being earned by the parent and the corresponding deduction by the subsidiary. If the subsidiary company is a 'loss corporation', it's possible the transaction will not create tax.

Not sure if you have these issues? Seek an independent opinion. Do not use your current audit firm. They should have already reviewed these issues with you so if they are not as trained in these areas, they will not see the issues.

1. Ask a peer organization to assess you while you assess their group. The risk is your peer may not know what to look for so the issues may still exist.

2. Hire another CPA firm that supports at least 100 non-profits. They will have the staff experience to identify if these issues exist at a reasonable cost.

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