



# SCCE Higher Education Compliance Conference

## IRS Compliance Project: Findings, Examinations, and Mock-Audits

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**VENABLE**<sup>®</sup><sub>LLP</sub>

 **BAKER TILLY**

# Presenters



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# Agenda

- Background
- Presentation Objectives
- Introductions and Group Activity
- IRS Compliance Project Interim Report
  - Overview, Findings, Contributions and Lessons Learned
- Preparing for an Examination
  - IRS 990 Mock Audit – Higher Risk Audit Target Areas in Higher Education
- Conclusion and Questions

# Background

- The Internal Revenue Service (IRS) Interim Report on the Nonprofit Colleges and Universities Compliance Project provides a wealth of information that can be used by colleges, universities, as well as other members of the tax-exempt community, to ensure compliance with applicable provisions of the federal tax code.
- To date, the IRS Compliance Project has resulted in thorough examinations of 30 colleges and universities, focusing on the areas of unrelated business income, executive compensation, related entities, and corporate governance.

# Presentation Objectives

- 1) Gain an understanding of the IRS Compliance Project Interim Report findings, which focused on unrelated business income, executive compensation, entity issues, and corporate governance.
- 2) Discuss lessons learned from the Interim Report, such as contributing factors to the findings.
- 3) Understand best practices and guidance to help organizations ready themselves for a review and perform a mock audit.

# Introductions and Group Activity

# 1) IRS Compliance Project Interim Report

- Key take-aways from the IRS Interim Report
- Significant findings
- Resource link - <http://www.venable.com/a-lesson-in-compliance--irs-releases-interim-report-on-nonprofit-colleges-and-universities-compliance-project-long-version/>
- Interim Report can be found at - [http://www.irs.gov/pub/irs-tege/cucp\\_interimrpt\\_052010.pdf](http://www.irs.gov/pub/irs-tege/cucp_interimrpt_052010.pdf)

# 1) Interim Report - Background

- Compliance projects
  - IRS broadly reviews an entire industry at one time
  - IRS will learn about the industry and compare each organization to other similar organizations
  - IRS will use this information to determine a range of reasonableness in reporting so that it can easily identify anomalous organizations as potential audit targets
  - IRS will also use this information to identify common areas of abuse and noncompliance which will be the focus of future IRS examinations in the industry
- Past compliance projects
- The colleges and universities compliance project



# 1) Interim Report - Background

- Past compliance projects
  - Hospital Compliance Project (2006) – 20 examinations
  - Credit Counseling Compliance Project – resulted in examinations of more than 80% of the industry as measured by revenue

# 1) Interim Report - Background

- The colleges and universities compliance project
  - Compliance questionnaires were sent to 400 colleges and universities, approximately 16% of the industry
  - As of June 2010, 30 examinations of colleges and universities were opened as a result of the compliance project
  - Four areas of common issues:
    - Unrelated business income
    - Compensation
    - Relationship with related entities
    - Corporate governance

# 1) Interim Report - Significant Findings

- Unrelated business income
  - Too few organizations report unrelated business income
    - Nearly half of the small colleges (5,000 or fewer students) reported that they have never filed a Form 990-T
    - 17% of medium and large colleges and universities reported having never filed a Form 990-T
  - Inconsistent reporting
    - More organizations reported engaging in unrelated activities in the compliance questionnaire than reported such activities on their Forms 990-T
  - Substantial confusion about transaction with related parties
  - Approximately 65% of organizations reported that they have never sought tax advice with respect to whether an activity results in unrelated business income

# 1) Interim Report - Significant Findings

- Compensation
  - Only about 50% of the small and medium sized colleges and universities that provide loans to officers, directors, trustees, key employees, or highly compensated employees reported that the terms of the loans were codified in writing
  - Less than 40% of all of the colleges and universities reported that they had a formal compensation policy
  - Less than a third of the organizations had sought the advice of an independent consultant in determining the appropriateness of the amount of compensation or the approval process

# 1) Interim Report - Significant Findings

- Corporate governance
  - Good news – a majority of organizations reported that they have conflict of interest and disclosure policies
  - Bad news - less than 40% of all of the colleges and universities reported that they had a formal compensation policy
  - As previously mentioned, less than a third of the organizations had sought the advice of an independent consultant in determining the appropriateness of the amount of compensation or the approval process

# 1) Interim Report - Significant Findings

- Related entities
  - More than half of the colleges and universities reported being related to either taxable or tax-exempt entities
  - Of these, less than half reported income from related entities on their Form 990-T

# 1) Interim Report - Take-Aways

- Unrelated business income
  - This is the number 1 issue of IRS focus
  - understand and report
- Compensation and governance
  - This is the number 2 issue
- Related entities –
  - Learn about the reporting requirements and follow them
- Seek outside help!
  - The IRS itself noted the lack of outside assistance used by these organizations in characterizing income, setting compensation, and establishing governance procedures

# 1) Interim Report - Why Should I Care?

- Unrelated business income
  - This is the issue that will most likely attract the attention of the IRS
  - On an examination this could result in significant tax liability with interest and penalties
  - If substantial, this could result in revocation



# 1) Interim Report - Why Should I Care?

- Compensation
  - Excessive compensation or payments to employees or independent contractors can result in revocation on the basis of a substantial private benefit or private inurement
  - Excessive payments to certain insiders may result in intermediate sanctions:
    - Recipient may be required to return the excessive portion of the compensation to the organization and pay an excise tax of 25% of the total benefit to the IRS;
    - Under certain circumstances the individual may be required to pay an additional excise tax of 200% of the penalty to the IRS; and
    - Certain individuals who approved or participated in the transaction may be required to pay an excise tax of 10% of the excessive amount of the benefit

# 1) Interim Report - Why Should I Care?

- Corporate Governance
  - Proper governance is the best way to protect against excessive compensation and inappropriate transactions
  - On an examination good governance may cause the IRS to view other potential issues more favorably

# 1) Interim Report - Why Should I Care?

- Related entities
  - Failure to understand the impact of transactions with related entities could cause organizations to receive unreported unrelated business income and enter into transactions that run afoul of the compensation requirements

## 2) Contributions and Lessons Learned

- Major contributing factors to the findings.
- Lessons learned from the focus areas of the examinations.
- Risk mitigation factors of a future IRS examination and prevent putting their tax-exempt status in jeopardy

## 2) Contributions - Basis for IRS Findings

- Arrogance and ignorance
  - Arrogance
    - Approximately 65% of colleges and universities reported that they had never obtained an opinion from a tax advisor regarding UBI
    - Less than 30% of the organizations reported that they used an independent consultant to determine the appropriateness of compensation
  - Ignorance
    - Nearly half of the small colleges surveyed reported that they had never filed a Form 990-T
    - Organizations reported unrelated compensation in the compliance check questionnaire that they were not reporting on their Form 990-T
    - Organizations may have been mischaracterizing income from such entities

## 2) Lessons Learned - Future IRS Examinations

- Issues to prepare for:
  - Unrelated business income
  - Compensation
  - Corporate governance
  - Related entities

## 2) Lessons Learned - Risk Mitigation

- Understand your organizations activities and how income derived from those activities should be characterized
- Implement the necessary governance procedures to ensure compliance
- **ASK FOR HELP!**
  - Before an examination
  - During an examination
  - If necessary, after an examination

### 3) Preparing for Future Examinations

- Guidance from the perspective of Internal Audit.
- Who?
- What ?
- Where ?
- When ?
- How?
- Why?



## IRS 990 Mock Audit - Higher Risk Audit Target Areas

- Unrelated business income tax (UBIT)
- Executive compensation
- Tax-exempt ruling review; other IRS rulings
- Board and Committee governance
- Employee benefits
- Loan guarantees
- Related party/joint venture transactions
- Charitable contribution substantiation
- Worker classification
- Listed transactions
- Nondiscriminatory policies as to students
- Donor advised funds

## IRS 990 Mock Audit - Higher Risk Audit Target Areas (continued)

- Record retention
- Scholarships, fellowships, tuition reduction, education assistance, and other similar programs
- Tax-exempt debt
- Tax information reporting (TIR)
- Lobbying

## IRS 990 Mock Audit - Higher Risk Audit Target Areas

#	Audit Target Areas	Sample of Audit Procedures	Highlighted Areas of Risk within the Higher Education Institutions
1	<b>Unrelated Business Income Tax</b>	Review income from bookstore sales, sales of mailing lists, income from conference activity, income from the rental of facilities, income from the public use of facilities, advertising/endorsement income for inter-collegiate athletics, advertising income from the institution's radio station, student newspapers, etc.	Unrelated business income can generate tax underpayments, interest and penalties, and, if excessive, poses a risk to the institution's tax-exempt status.
2	<b>Executive Compensation (severance pay, non-qualified retirement plans, substantiation)</b>	Review written compensation policy, employment contracts, agreements, and other contracts for highly compensated individuals, including contracts with related organizations which may also have paid compensation to these individuals; review other forms of compensation such as furnishing goods, services, or facilities, transfers of property, leasing property, lending of money or other extensions of credit	Inadequate substantiation of reimbursed business expenses can result in tax underpayments and audit excess benefit transactions. Intermediate sanctions can be assessed which pose a risk to disqualified persons, individuals who approved the transaction and can also include reconciliation of the institution's tax exempt status.

## IRS 990 Mock Audit - Higher Risk Audit Target Areas

#	Audit Target Areas	Sample of Audit Procedures	Highlighted Areas of Risk within the Higher Education Institutions
3	<b>Tax-exempt ruling review; other IRS rulings</b>	Review exemption letters and original application for exemption; review subsequent amendments and changes filed with the IRS to notify the IRS of changes in organization or operations; review rulings received, including IRS Revenue Agent Reports, Appeals Settlement Agreements, Closing Letters, etc.	Failure to notify the IRS of significant changes in the organization or to operations of the organization could pose a risk to tax exempt status. If unable to produce an exemption letter the organization can request one from the IRS.
4	<b>Tax Information Reporting</b>	Review Form 1042 and withholding; Form 1099 reporting; Foreign Reporting; and Investment and Pass-through reporting.	Failure to report can result in fines and penalties.

## IRS 990 Mock Audit - Higher Risk Audit Target Areas

#	Audit Target Areas	Sample of Audit Procedures	Highlighted Areas of Risk within the Higher Education Institutions
5	<b>Board and Committee (governance and conflicts of interest)</b>	<p>Review Articles of Incorporation and bylaws; activities of the Board and committees including minutes of the Board and all committees; review systems or procedures in place to ensure that the use of assets is consistent with the institution's mission.</p> <p>Review conflict of interest policies and reporting of recusals or actual or potential conflicts of interest.</p>	<p>Failure to properly record Board and committee activities, failure to provide systems or procedures to ensure that activities of the university are consistent with the university's mission suggests a lack of institutional oversight.</p>
6	<b>Employee compensation and benefits (form W-4 compliance and student FICA exemption)</b>	<p>Review employee handbook, provision of daycare facilities, tuition reimbursement, mortgage assistance, housing allowances, meals allowances, automobile use, employee benefits plans.</p>	<p>Failure to properly report employee benefits can result in a tax underpayment, the imposition of an excise tax, the loss of qualified status of an employee benefit plan, and poses risk to the institution's tax-exempt status.</p>
7	<b>Loan guarantees</b>	<p>Review loan guarantees to determine the business purpose for the guarantees.</p>	<p>Guarantees inconsistent with tax-exempt purpose may result in unrelated business income tax and can pose a risk to the institution's tax exempt purpose.</p>

## IRS 990 Mock Audit - Higher Risk Audit Target Areas

#	Audit Target Areas	Description of Audit / Comments	Highlighted Areas of Risk within the Higher Education Institutions
8	<b>Related party/joint venture transactions</b>	Review related party and joint venture activity including agreements to perform research.	Failure to properly structure and report related party and joint venture activity can result in a tax underpayment and could pose a risk to the institution's tax-exempt status.
9	<b>Charitable contribution substantiation (other appreciable property and gift acceptance policy review)</b>	Review a list of contributions of intellectual property and the valuations of contributed properties.	Failure to properly document and reasonably value contributed intellectual property can result in substantial penalties and poses a risk to the institution's tax-exempt status.
10	<b>Worker classification</b>	Review classes of employees and their contracts for services; review independent contractor agreements; review engagements of former employees to provide services in a nonemployee status.	Failure to properly classify workers can result in an employment tax liability.

## IRS 990 Mock Audit - Higher Risk Audit Target Areas

#	Audit Target Areas	Sample of Audit Procedures	Highlighted Areas of Risk within the Higher Education Institutions
11	<b>Nondiscriminatory policies as to students</b>	Review the institution's racially nondiscriminatory policy, brochures, catalogs, and other written advertising dealing with admissions and scholarships; review materials used by the institution to attract minority students and faculty; review materials used by the institution to solicit contributions.	Failure to comply with the rules of Rev. Proc. 75-50 can pose a risk to the institution's tax-exempt status.
12	<b>Donor Advised Funds</b>	Review Donor Advised Funds activity.	Failure to properly report Donor Advised Funds activity can result in substantial financial penalties and poses a risk to the institution's tax-exempt status.

## IRS 990 Mock Audit - Higher Risk Audit Target Areas

#	Audit Target Areas	Sample of Audit Procedures	Highlighted Areas of Risk within the Higher Education Institutions
13	<b>Record retention</b>	Review the institution's record retention policies and assess systems in place to ensure compliance with this policy.	Failure to provide a system for record retention and a system to ensure compliance with this system suggests a lack of institutional control.
14	<b>Scholarships, fellowships, tuition reduction, education assistance, and other similar programs</b>	Review a list of recipients of scholarships, fellowships, tuition reduction, education assistance, and other similar programs to assess compliance with nondiscriminatory policies and proper reporting of these assistance activities.	Failure to comply with nondiscriminatory policies and failure to properly record and report educational assistance activities can result in a tax underpayment and poses risk to the institution's tax-exempt status.



# Thank You



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