

NONPROFIT PERSPECTIVES

Exempt Organizations' IRS Priorities

Congress makes the laws, Treasury interprets the laws, and the Internal Revenue Service (IRS) enforces them and collects the revenue.

But because the IRS has a limited budget, its Tax Exempt and Government Entities Division (TE/GE) has set priorities for enforcement in 2016. In this article, we'll review those priorities and discuss how tax-exempt organizations can focus their compliance efforts accordingly to avoid penalties up to and including loss of tax-exempt status.

TE/GE PRIORITIES FOR FY 2016

In order to be more effective and efficient, TE/GE is taking steps to streamline processes, digitize information, and manage knowledge. Most significantly, the IRS is focusing on data-driven decision making—issues where it believes there is a greater risk of noncompliance and therefore, a greater return on its investment of time.

The IRS takes the position that tax exemption is a privilege and not a right. Therefore, the objective is to ensure that organizations that were granted tax-exempt status are in compliance with the tax laws.

With this objective in mind, their priorities list five main strategic areas of focus. In their efforts to pursue the outlined strategic areas, TE/GE will use various approaches, including:

- **Field examinations:** In-person examinations.

- **Correspondence audits:** This is where the IRS sends a letter to the organization asking the organization to send documents to the IRS by mail and to have phone conversations. These audits are usually more limited in scope but can become extensive and ultimately turn into field examinations.

- **Compliance checks:** This is not an examination, but rather a check by the IRS to see if the organization has been properly reporting an item.

- **Compliance reviews:** This is where the IRS follows up to see if certain actions, outlined by an organization, have been taken.

Even if your organization receives a notice that it is part of a compliance check, it is important to respond to all IRS correspondence, because the IRS could turn a compliance check into a full-blown field examination.

The highlights of the five strategic areas of focus are:

1. *Exemption: Issues include nonexempt purpose activity and private inurement, enforced primarily through field examinations.*



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Your organization filled out an application for exemption (either Form 1023 or 1024). If your organization is conducting activities other than those indicated on the form, ask yourself if they are related to exempt purposes. If the activity is unrelated to exempt purposes, is the income being reported as unrelated business income? Most importantly, does the activity constitute more than an insubstantial amount of the organization's activities? The term insubstantial is not defined, so the facts and circumstances must be reviewed. More than an insubstantial amount of unrelated activity can cost an organization its exemption.

2. Protection of Assets: Issues include self-dealing, excess benefit transactions, and loans to disqualified persons, and are enforced primarily through correspondence audits and field examinations.

Are transactions at arms-length and for fair-market value? Private foundations have strict rules as to what constitutes self-dealing, and it can be direct or indirect. Public charities and social welfare organizations can establish the rebuttable presumption of reasonableness so that transactions with disqualified persons can be vetted by independent persons and decisions can be made based on comparable data. If the decision-making process is contemporaneously recorded, the rebuttable presumption can be established, which would shift the burden of proof to the IRS to show that the transactions were unreasonable.

3. Tax Gap: Issues include employment tax and Unrelated Business Income Tax (UBIT) liability, enforced through compliance checks, correspondence audits and field examinations.

These are the two biggest revenue generators for the IRS with respect to exempt organization compliance. The major issue for employment taxes is whether individuals have been properly classified as independent contractors as opposed to employees, and in any event, whether the proper forms were filed. The IRS, more often than not, prevails on these issues.

Regarding unrelated business income (UBI), the typical tactic that the IRS takes is to disallow losses from one activity to offset income from another activity if the loss activity has lost money for several years. In this instance, the IRS will take the position that there is no profit motive, which is a requirement for a trade or business. If there is no trade or business, then there cannot be an unrelated trade or business and therefore, those losses cannot be used to offset UBI.

4. International: Issues include oversight on funds spent outside the U.S., including funds spent on potential terrorist activities, exempt organizations operating as foreign conduits and Report of Foreign Bank and Financial Accounts (FBAR) requirements. These are enforced through compliance reviews, compliance checks, correspondence audits and field examinations.

If a private foundation makes a grant to a foreign organization, it must either exercise expenditure responsibility over the grant or have an opinion from a qualified person that the foreign organization is the equivalent of a U.S. public charity.

Another concern regarding foreign organizations is that of a U.S. charity merely being a conduit to receive tax-deductible contributions that are going straight to the foreign charity without the board of the U.S. charity having discretion over the use of the funds. The potential abuse here is that only contributions to U.S. charities are tax-deductible for income tax purposes.

Of course, the IRS is also concerned that charitable donations are being used to fund foreign terrorist organizations. The Office of Foreign Assets Control (OFAC) releases a List of Specially Designated Nationals and Blocked Persons with names of individuals and entities that may be engaged in terrorist activities. Organizations should check the lists prior to making grants and engage in procedures to ensure that foreign expenditures or grants are not diverted to support terrorism or other non-charitable activities. In addition, organizations should comply with all U.S. laws and orders that restrict activities with certain countries or individuals because of economic sanctions.



Exempt Organizations' IRS Priorities cont..

5. Emerging issues: Issues include nonexempt charitable trusts and the Internal Revenue Code (IRC) section 501(r), enforced through compliance reviews, correspondence audits and field examinations.

Tax-exempt hospitals now have to be in compliance with Final Regulations under IRC section 501(r) for tax years beginning after Dec. 29, 2015. Congress has mandated that every tax-exempt hospital will be reviewed at least every three years to see if it is in compliance with the rules.

Also, the IRS will be looking at charitable trusts that are not exempt from tax to make sure that they are not violating rules, particularly since they are subject to some of the same requirements and restrictions that apply to private foundations.

In addition to the priorities of TE/GE, the Treasury listed 13 areas where it will provide priority guidance for exempt organizations, including allocation of expenses for dual-use facilities and a new method for charities to provide contemporaneous written acknowledgements (CWAs) for gifts greater than \$250, according to the Federal Register. In this instance, the charity would have to collect Social Security numbers from donors in order to comply. Such a proposal could raise a number of concerns pertaining to cyber security risks.

CONCLUSION

The IRS has become much more efficient and effective in its examination activities related to exempt organizations. Although the examination rate is lower for exempt organizations than for other taxpayers, TE/GE is attempting to better target its examinations for improved results. One final note: the IRS still relies on trustworthy outside data and public information, so it's important to make sure that your organization is accurately portrayed in the media and on its Form 990, which is a public document available on www.guidestar.org.

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