

IRS Audits: How to Avoid or Prepare

Under the best of circumstances, even the mention of an audit by the Internal Revenue Service (IRS) can provoke anxiety in the fiercest among us, given the IRS's power over tax-exempt status. An audit can drain valuable resources, including time, away from a nonprofit organization's (NPO's) core mission. But there are things NPOs can do to avoid audits, and if one occurs, to handle it effectively. We let some experts weigh in on the [best ways to avoid or manage an audit](#). Their insights are below.

How does the IRS choose which nonprofits to audit?

The IRS is very interested in the international activities of tax-exempt organizations. With relatively limited data about international activities available on Form 990, the IRS often relies on complaints or referrals from other government agencies. Concern about terror funding permeates government all government activity.

Five Strategic Risk Areas

In Fiscal Years 2016 and 2017, the IRS's Exempt Organizations division has [focused on five strategic risk areas](#) in audits of nonprofit organizations:

1. Exemption – non-exempt purpose activity and private inurement, enforced through field examinations
2. Protection of assets – issues include self-dealing, excess-benefit transactions, and loans to disqualified persons, enforced through correspondence audits and field examinations
3. Tax gap – issues include employment tax and unrelated business income tax liability, enforced through compliance checks, correspondence audits and field examinations
4. International – issues include oversight on funds spent outside the US, including funds spent on potential terrorist activities, exempt organizations operating as foreign conduits, and Report of Foreign Bank and Financial Accounts (FBAR) requirements, enforced through compliance reviews, compliance checks, correspondence audits and field examinations
5. Emerging issues – issues include non-exempt charitable trusts, and IRC 501(r), enforced through compliance reviews, correspondence audits, and field examinations

Credits:

Information for this guide was sourced from a Charity & Security Network webinar with presentations by Alex Reid of Morgan Lewis; Marc Owens of Loeb & Loeb LLP; and Lara Kalwinski, formerly of Council on Foundations and now with Zakat Foundation.



Traditionally, the IRS used what they called a risk-based approach, focusing on various types of nonprofits or entities they deemed to be at greater risk of noncompliance. Recently, the agency has shifted to the [use of analytics via data submitted on the Form 990](#), the annual tax return form for tax-exempt organizations. In doing so, the IRS uses approximately 150 different queries. If an organization “fails” too many of these, they are likely to be audited. It also analyzes data from Form 1023 applications for tax-exempt status to identify trends and patterns, and uses change rate data and statistical sampling in tax-exempt bonds to identify market segments with a higher risk of noncompliance.

In switching to this method, the agency is seeking to eliminate subjectivity, but also casting a wider net for audits. However, not all audits will look like audits. With limited resources, it is focusing on the most effective and least-intrusive methods. These include educational efforts, compliance reviews and checks, correspondence, and field examinations. [To do this, the IRS will:](#)

- Stratify the universe of exempt organizations into major subsections and initiate new cases among each subsection
- Use data to determine which issues to focus on
- Use stakeholder input, reliable outside data, and public information

Any government agency, organization or individual can refer a complaint to the IRS - many audits are driven this way. Many times, the media will ramp up attention about an organization. Nonprofits should realize that media reports, internet postings, and social media are all publicly available and could be viewed by regulators. The IRS tends to be sensitive to media reports.

There is also a [whistleblower procedure](#) in which an ordinary citizen can file a complaint that could result in a monetary award. The IRS will review the whistleblower complaint, and may or may not act upon it, but because audits are confidential, it is impossible for the whistleblower to know if his/her complaint led to an audit.

That's a lot of information to take in. How do I avoid being audited?

First and foremost, file a complete return (Form [990](#), [990-PF](#) and/or [990-T](#)). Fill out all the necessary boxes and schedules. This will start the statute of limitations running, which bars the government from assessing and collecting tax after a set number of years - three years after filing a complete return, six years after a materially incomplete return. If you do not file a return, there is no statute of limitations, meaning that the government can come after you at any time. You should also know that the IRS takes the position that the statute of limitations does not bar the agency from revoking an organization's tax-exempt status retroactively back to the year in which inappropriate acts occurred, even if the statute of limitations bars the IRS from collecting tax other than from the three or six most recent tax years.

Getting Into the Weeds

Consistency in [Form 990](#) reporting is essential. Pay attention to required cross-references:

- Program expenses - total program expenses should be the same in Part III, Line 4 and Part IX, Line 25, column (B)
- Unrelated business income – if reported in column (C) of Part VIII, you should also report that a Form 990 T was filed on Part V, Line 3b
- Insider transactions – if you prepare Schedule L to report an insider transaction, you should also report on Part VI, Line 12 that the organization implemented a conflict of interest policy
- Checklist of required schedules – if you respond affirmatively in Part IV, you should complete the applicable Form 990 Schedule

Tips for Avoiding an Audit

Schedule F. Pay particular attention to your [Form 990 Schedule F filing](#), if required. This asks about your activities outside the U.S. – you must list the region(s) in which you worked, the number of offices and employees you have there, the activities you conduct there, any investments you have in those region(s), and all grants to recipients located there, among other information. If you list an activity, you need to describe the specific type of service, and the total expenditures in that region.

In the second part of Schedule F, list any grant made to a recipient that receives more than \$5,000 from you. Part IV has a list of forms that you will need to complete any time you transfer property to a foreign corporation (see [IRS Form 926](#)). Part V provides space for supplemental information, where you can provide any info that would help an agent understand the information you provided in Part I or II. If you have an issue that is complicated and requires a lot of discussion, provide a paragraph description either in [Part V of Schedule F \(“Supplemental Information”\)](#) or in [Schedule O \(“Supplemental Information to Form 990”\)](#) of your 990.

Mission and operations. On a regular basis, internally review your organization to make sure that you are in compliance with all of your stated policies, that all the things you say on your Form 990 returns are in fact true, and that your governing documents are consistent and up-to-date with the way that you currently operate. Make sure that your current operations are in line with your Form 1023 application or as reported on Form 990. Look back at your IRS determination letter to ensure that you are still operating within those parameters. Determine if you have had “mission creep,” and whether you are comfortable with where your organization is operating now, compared to the activities described in your original application. Activities that are disclosed in Form 1023 and approved by the IRS are permitted. If you have drifted from that, you should update the IRS about how your operations have changed. [Structural and operational changes to an organization must be reported to the IRS.](#)

Employees and contractors. File the appropriate forms for employees and withhold taxes. Because the IRS is focused on revenue generation, many audits focus on areas where exempt organizations are responsible for collecting and paying taxes. In particular, the employment area can become an area of concern. If the people whom you compensate for services are employees, you must file [Form W-2s](#) for each of them and collect payroll taxes. If they are independent contractors, file [Form 1099s](#).

Foreign withholding. [Withhold tax for nonresident aliens](#). In the international context, foreign withholding is a big area for the IRS. If you pay compensation for services to a nonresident alien, and those services are rendered in the United States, you must withhold taxes from their compensation and file the proper information returns with the IRS. If you fail to do this, you are responsible for the tax, which is 30% of the payment for services. Because US government does not have much jurisdiction over that foreign person, the presumption shifts to the payor (nonprofit organization) to collect the tax.

At the end of the day, however, the IRS selection process is still popularly referred to as the “audit lottery.” Even with all of the selection methodology in place, the probability that your organization will be chosen is low, given the number of tax-exempt organizations.

If my organization is chosen in the “audit lottery”, how should I prepare?

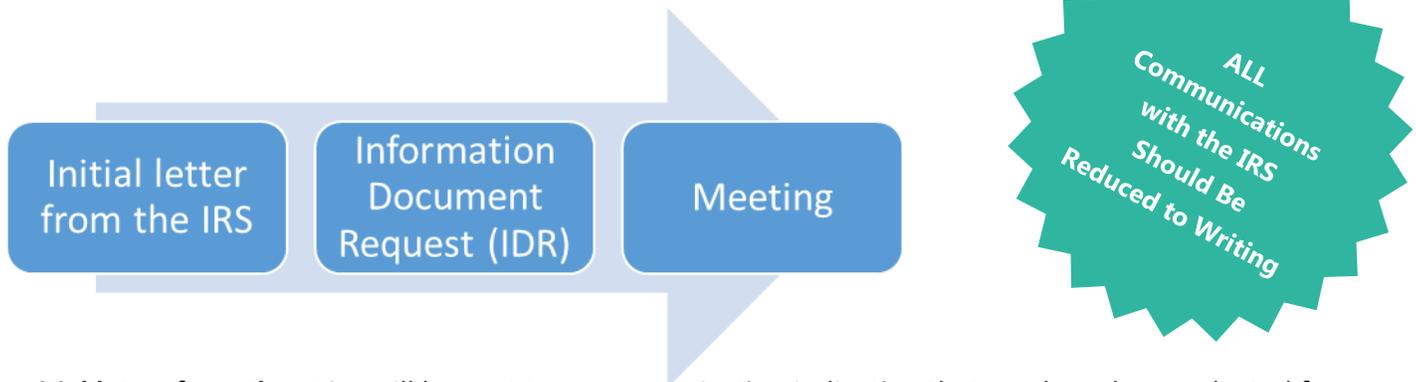
Treat every IRS interaction as an important one.

Decide how you will manage the audit: you can try to handle it yourself, have accountants or tax preparers handle it, or hire an attorney. If you hire counsel, do so *as early in the process as possible*.

Be prepared to discuss [executive compensation](#), [lobbying limits](#) or impermissible [electioneering](#) – the IRS will always review these three items at a nonprofit organization, regardless of the reason for the audit. The only exception is with a limited scope examination, such as one focused on employment taxes. Remember that lobbying activity is permissible, within limits, but electioneering is not.

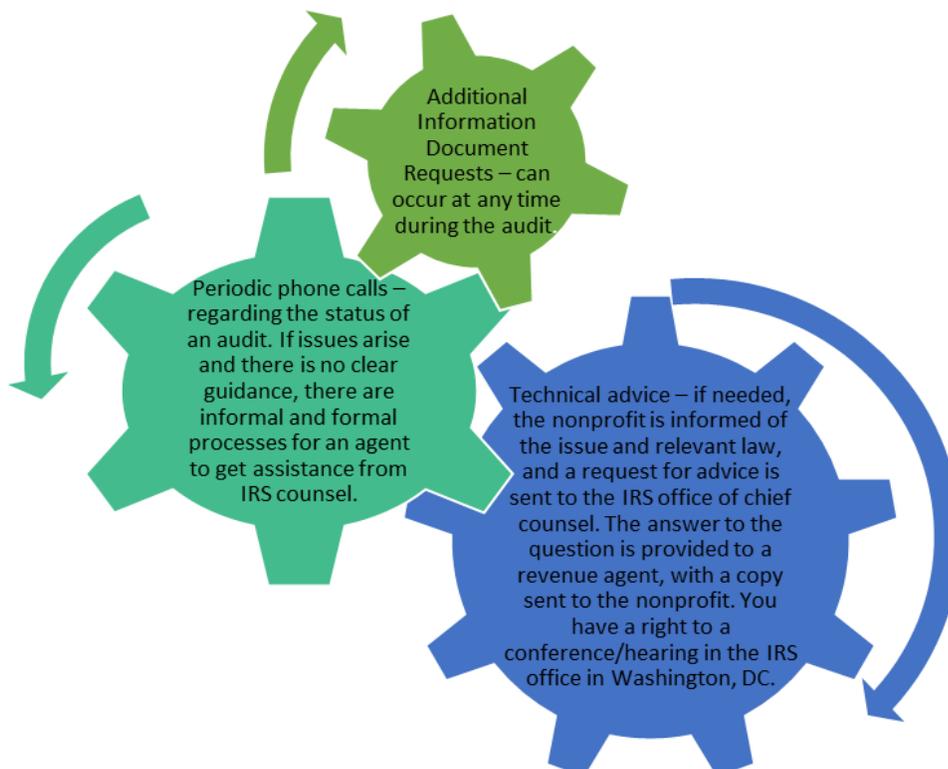
Ok, now what should I expect from this process?

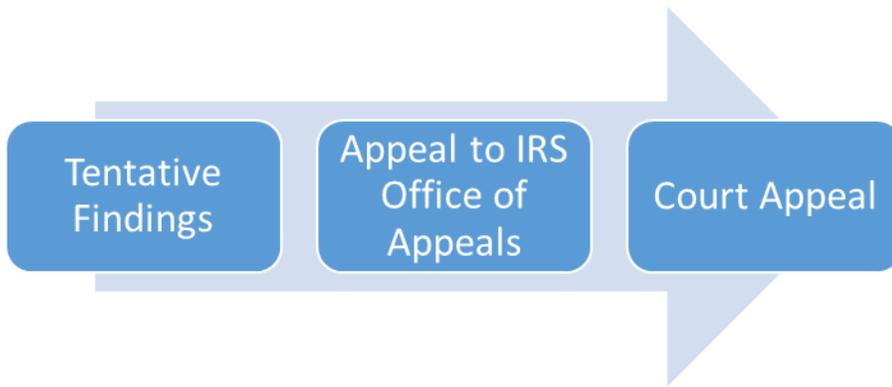
An [IRS audit](#) progresses through several steps:



Initial letter from the IRS – will be sent to your organization indicating that you have been selected for a review. This initiates the process. It will specify whether the process will be a [field audit](#) or an [office/correspondence audit](#). If the letter states that the IRS is conducting a [compliance check](#), you are not being audited, but the check can become an audit. The [scope of audits and compliance checks](#) are different.

- The letter will provide the tax year(s) under review - you should limit the information you give the IRS to this time frame. If you volunteer information from other tax years, it could have negative consequences. Note, however, the IRS can request information from earlier years that relates to a matter in the year under examination, for example, the purchase of an asset years ago that is used in an unrelated trade or business and later sold in the year under audit would be important for calculating potential income tax on the sale. Before declining to provide information, you should consult with your tax advisor as such a declination could lead to an administrative summons.
- Note the name and contact information of the revenue agent assigned to your case and his/her manager.





Information Document Request (IDR) – will be included with the letter.

The agency will specify a time period within which it wants a response, but you can request an extension. Be sure to let the IRS know if any of its requests are unduly burdensome.

Meeting – the IRS should meet with you at beginning of the audit. The revenue agent and his/her manager should be there. There are three kinds of revenue agents:

- General/regular revenue agent – an accountant, assigned to routine audits.
- Financial investigative agent - in cases involving international activities, with any link to OFAC licenses or sanctions, or if there is any indication of concern with terrorism financing or if the IRS anticipates that complex issues will be present in your audit. They have much more training, particularly in forensic accounting, and support criminal investigations or handle more complex audits. They are more aggressive and will ask tougher questions, but often coordinate with agents who do.
- Criminal investigator – if your case is a criminal investigation. They generally do not have any particular knowledge about tax-exempt organizations.
- If this is a field audit, an agent will conduct an [on-site examination](#). In an office/correspondence audit, a limited-scope examination of a few issues is conducted in an IRS office or through correspondence.

Pro Tip:

After the initial contact from the IRS, there is an opportunity to expedite the resolution of your audit by meeting with the audit team and making your case. You can spare your organization a lot of pain down the road if you come prepared with a full description of your position on the case.

Usually, the reason for any kind of failure or noncompliance is a misunderstanding or a small oversight. You want to be able to put that into context, to talk about the great stuff your organization does, and why there might have been a mistake.

Failing to take the opportunity to offer these explanations can lead to a much longer and more difficult process.

Tentative findings – after the agent has finished the fact gathering and analysis.

- If the outcome is favorable, the process concludes. You will get a letter with suggestions, if the IRS believes that adjustments will help avoid future problems.
- If the outcome is adverse, there will be an informal discussion of the issue and suggested changes. You have the right to submit additional information.

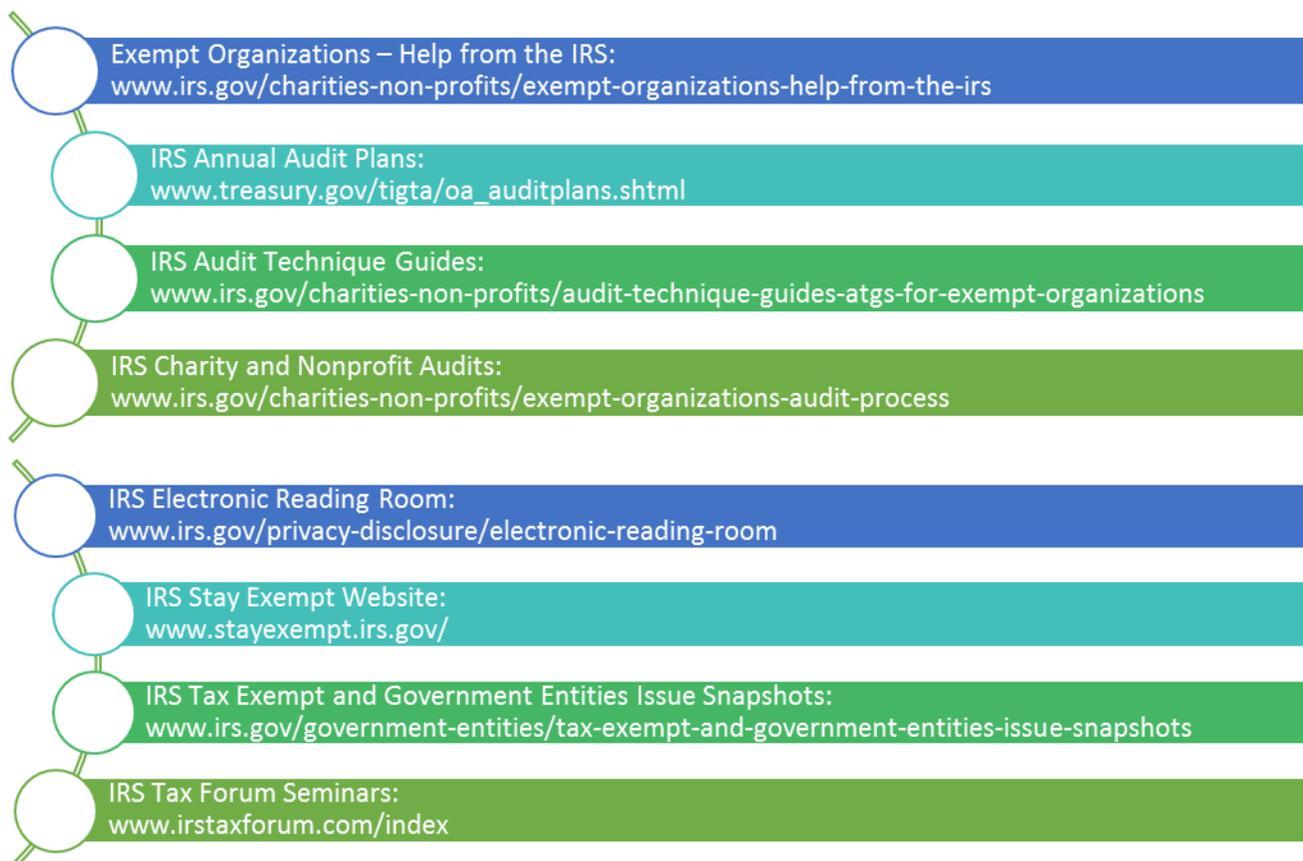
Appeal to the IRS office of appeals – if you are unable to persuade the agent to the correctness of your organization’s position, you will be offered the opportunity have the case transferred to IRS Appeals for a conference. That hearing is a *de novo* review – the hearing officer will review the case as if for the first time. You have a right to a phone conference or a face-to-face meeting in this office. There, an appeals officer will either discuss a negotiated resolution of your case, or hold against either the agent or nonprofit organization.

- If the officer finds against your organization, you will get an action letter describing an assessment of taxes or a revocation of your tax-exempt status.

Appeal to the Courts – if the officer finds against your organization, you can appeal to a court. For charities with exemption issues, three courts are available:

- Tax court (can be done before an assessment or payment is made)
- U.S. District Court for the District of Columbia

For More Information



Find out more about protecting your nonprofit organization in our Know Your Rights series of webinars and other resources at charityandsecurity.org/knowyourrights

