

**IRS Nonprofit Audit Targets**  
**Is your organization in the cross hairs?**  
**Here's what to watch out for...**

*By Andrew Dzamba*

Because the tax laws under which nonprofit organizations operate are complicated, most organizations make inadvertent mistakes in filling out their annual Form 990. What follows is a quick checklist of nonprofit tax issues that the IRS is particularly interested in. That means that they are likely audit targets, and as such, they demand special care in the way your organization handles them:

**Gambling fundraisers:** Sometimes the income from nonprofits' gambling fundraisers (e.g., bingo, pull-tabs, Las Vegas nights, etc.) is taxable as unrelated business income (UBI), but the organization is unaware of it. For example, a court recently ruled that income from selling instant bingo tickets is taxable as UBI.

Also, in recent years, several organizations have lost their tax-exempt status because too much of their operations consisted of running gambling fundraisers and not enough of the money raised went to charitable program services.

In addition, the IRS has found cases of improper private gain, particularly in instances where charities hire outside professional operators to run their gambling events. The IRS is also stepping up its efforts to see that tax withholding rules for gaming fundraisers are being followed.

**Tax-exempt bonds:** IRS agents have been instructed to scrutinize the effect of financing with tax-exempt bonds on an organization's tax-exempt status. While commercial mortgages, taxable bonds, and private financing may be used in acquiring and constructing facilities, the IRS believes that transactions financed by 501(c)(3) organizations with proceeds of tax-exempt bonds merit special scrutiny.

**Joint ventures:** Joint ventures between nonprofits and for-profits have always been under close scrutiny by the IRS. The reason is that these ventures can easily stray from serving primarily charitable needs. In particular, joint ventures between nonprofit and commercial health care organizations are examined very closely.

**Travel tours:** Many organizations—from universities to religious groups—

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that sponsor educational travel tours have been under fire recently from for-profit travel agencies. The commercial travel agents feel that nonprofits are competing unfairly because they pay no tax on the travel tour income, even though many tours are identical to commercial junkets. The IRS has responded with a set of new rules designed to give nonprofits clear guidance as to when a travel tour is truly educational and its income is UBI tax free.

**Retirement plans:** So many nonprofits make mistakes in their employees' retirement plans—particularly tax-sheltered annuities, or 403(b) plans—that the IRS recently started a voluntary compliance program. Under this program, nonprofits may correct errors in their plan without the plan losing its tax-favored status. (If that status were to be removed, plan participants could lose all of their tax deferrals and face back taxes and penalties.) The most common problem with these plans is that too much money is being contributed to the plans on a tax-deferred basis. The rules are complex, so even the largest nonprofits slip up.

The IRS is also finding lots of errors in Section 457 plans (also called “top hat” plans), which are deferred compensation plans that nonprofits offer to their key executives.

**Private gain:** A nonprofit's money or property must be used for public—not private—benefit. But through complex compensation and fringe benefit arrangements, joint ventures with for-profits, and commercial income ventures (including for-profit subsidiaries), many nonprofits may be unwittingly conferring private gain on insiders. For example, the IRS has been finding that many organizations aren't including fringe benefits in the taxable compensation of their top managers. Employer-provided automobiles, on-site parking, imputed interest on loans to insiders that carry below-market interest rates, and the use of employer-provided living quarters are not being reported as taxable pay.

**Payroll taxes:** At many educational organizations, two trouble spots are cropping up with regard to payroll taxes: (1) the student Federal Insurance Contributions Act (FICA) tax exemption and (2) withholding and reporting for foreign students. Concerning student FICA, if an educational organization employs a student who is regularly attending classes, there are no FICA taxes to withhold and match. Generally, a student who is enrolled in 12 or more credit hours and is employed for 20 hours or less is exempt from FICA. But student workers with less than 12 credit hours can also qualify for the FICA exemption.

As for withholding for foreign students, there's no withholding of taxes on the portion of scholarships or fellowships paid to foreign students that's attributable to tuition, fees, or books. But other amounts, such as for room, board, or travel, are taxable. Also, payments made to a foreign student for services he or she must render in order to receive a scholarship are taxable. A Form 1042-S must be filed for scholarships and fellowships paid to foreign students. If compensation is paid to foreign students, and there are taxes withheld, a Form W-2 must be filed.

**Independent contractors:** In past nonprofit audits, more than half of the organizations faced employment tax headaches stemming from independent contractors. The organizations were classifying workers as independent contractors when they were really employees. With independent contractors, you don't have to worry about payroll taxes or benefits. But worker classification is tricky—which is why many nonprofits slip up. The employer has to pay back taxes, with possible interest and penalties. And this tough penalty is imposed regardless of whether the workers paid the right amount of tax on their own. The IRS has collected millions from nonprofits over this issue, and it will continue to pursue it.

**Nonprofits' limited liability companies (LLCs):** Many nonprofits are forming single-member LLCs for various purposes under what are known as "check-the-box" rules. These rules allow a sort of "default" into so-called disregarded status for these LLCs. The IRS is exploring whether nonprofits need to apply for separate exempt status for these entities, based on Section 508 of the tax law. That section requires that new charities notify the IRS by applying for exempt status within 15 months. If the LLCs fall under this requirement, they would have to declare their income and assets on a Form 1023, "Application for Recognition of Exemption."

One factor the IRS is looking at that would trigger filing is whether the LLC conducts a nonexempt activity that bears a close relationship to the activity of the parent nonprofit. The presence of UBI would also be a factor.

**Health care conversions:** Close attention is being paid to health care conversions at both federal and state levels. The IRS has examined several joint ventures in order to get a better understanding of how the transactions are structured and to identify areas where problems are likely to occur. Nonprofits should expect the IRS to support state attorneys general in their work dealing with disclosure in such cases. In recent guidelines for whole hospital joint ventures [Rev. Rul. 98-15], it's clear that if such a joint venture does not meet the standards described in those guidelines, the best approach

is to bring in all of the regulatory agencies with an interest in the resolution of the noncompliance.

**Internet-related activities:** The IRS is scrutinizing three areas of nonprofit Web activity: (1) political intervention, (2) lobbying, and (3) advertising income. Although there is no official guidance from the IRS yet on Internet activity by tax-exempt organizations, the government has consistently treated the Web as another medium of communication—akin to newsletters, pamphlets, and any other published material a nonprofit produces. Therefore, the existing tax law rules with regard to the scrutinized activities will likely apply.

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