



Don't Make the Same Mistakes – Lessons from IRS Examinations

2023 GWSCPA Nonprofit Symposium

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With you today

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Agenda items

- IRS TE/GE Update
- IRS Audit Activity
- Possible IRS Audit Selection Triggers
- Sample IDRs – How to manage
- Open Q&A

IRS Tax exempt and government entities (TE/GE) update

- **Service:** Enhanced Taxpayer Service
 - Taxpayer Digital Communications
- **Enforcement:** Strengthen Compliance Activities
 - Data, Machine Learning, AI
 - Collaboration across IRS on emerging issues
- **People:** Workforce Development
 - Increased Hiring
 - Frontline Leadership Readiness Program
- **Transformation:** Transform Operations
 - More electronic filing of returns
 - Updated TE/GE Examination Internal Revenue Manual (IRM)

2023-2024 Priority Guidance Plan E/Os

- Group Exemption Letters
- Final Regulations §509(a)(3) Supporting Orgs
- Regulations regarding allocation of UBI expenses
- §4941 Guidance on self-dealing tax regarding private foundation's investment in partnership with DQ persons who are partners
- §4958 and §4966 donor advised funds regulations
- Guidance on public-support computation with respect to distributions from DAFs

TIGTA Report on TE/GE Performance

- Over 5-year period TE/GE failed to adequately respond of 30K taxpayer inquiries (Jan 2017 – May 2022)
- No performance metrics or goals to measure effectiveness of customer service

IRS Audit activity

- Current exam data from IRS FY22 Accomplishments Letter
 - In FY22, the IRS opened 3,009 EO exams
 - In FY22, the IRS closed 3,425 EO exams (overall 78% change rate)
 - 938 data-driven cases (84% change rate)
 - 475 compliance strategies (86% change rate)
 - 2,012 referrals, claims and other casework (73% change rate)
- In FY22, the IRS proposed revocations for 53 tax-exempt entities because of these exams
- TE/GE continues to review approximately 3,000 tax-exempt hospitals (on a rolling 3-year basis) for adherence to IRC Section 501(r)
- In FY22, the IRS issued 842 compliance checks regarding Sec. 4960 (regarding excess compensation) – of those, 100 referred for examination

IRS Audit activity (continued)

- Focused on unrelated business taxable income (UBTI) reported on Forms 990-T where expenses materially exceed gross income
- IRS positions:
 - Disallowing expenses based on allegedly improper allocations between related and unrelated business activities
 - Disallowing net operating losses (NOLs) based on the alleged lack of a profit motive in carrying out the loss-generating activity

IRS Reveal Significant Increase in Excise Tax Payments

- The number of organizations paying §4960 excise taxes on excess compensation (generally compensation exceeding \$1M) tripled from 2021.
- Likely the result of compliance check letters sent by IRS as well as significant increases in compensation, which have caught the attention of House Committee on Ways & Means.
 - 2022: 1,710 organizations paid \$670,899,011
 - 2021: 516 organizations paid \$210,061,282
 - 2020: 302 organizations paid \$96,168,764
- The number of private colleges and universities that paid the §4968 excise tax on their net investment income (NII) for 2022 approximately doubled from 2021, and the total tax paid more than tripled.
 - 2022: 58 private colleges and universities paid \$243,710,847
 - 2021: 33 private colleges and universities paid \$68,088,906
 - 2020: Data not reported

Possible IRS audit selection triggers

- Unrelated Business Income
 - Allocation of Expenses/NOLs
- Executive Compensation
- Private Inurement/Self-Dealing
- Employment Tax
- Inconsistent or incomplete return
- Data Matching (W-2 and 1099)
- Refund or abatement claim verification
- Large, unusual or questionable items
- Tax-Exempt Bond Compliance
- Sometimes random (...dumb luck)

IRS TE/GE Compliance Examination Strategy

- Data Driven Approaches
- News Media
- Referrals (Internal and External)
- Federal and State Legislative Inquiries

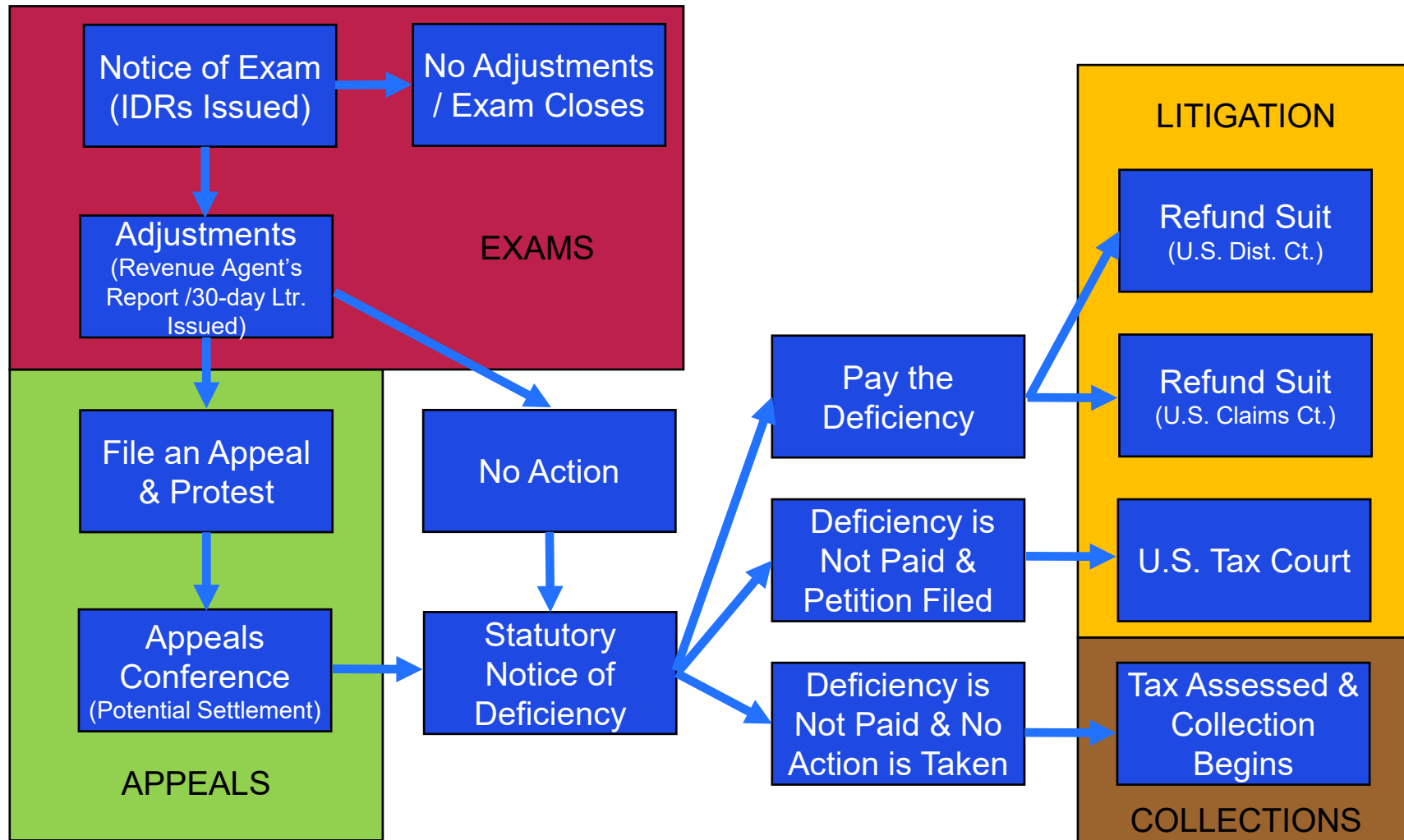
Purpose of and authority for the audit

- An IRS audit is an examination of a tax return to verify income, deductions, credits, exclusions, and other tax benefits to ensure that the tax liability reported is in fact the correct tax liability.
- IRC §6001
 - Taxpayers required to maintain books/records sufficient to establish items of income, deduction and credit reported on their returns.
 - Must be maintained as long as they may be material to the determination of any internal revenue tax
- IRC §7602(a)
 - IRS is authorized to examine any books, records or other data and to take such testimony that may be relevant or material.
 - To ascertain the correctness of any return or to determine liability of any person for any internal revenue tax

Types of IRS Audits

- Field Examinations
 - Revenue agents examine returns typically at the taxpayer's or representative's place of business
- Office and Correspondence Examinations
 - Taxpayer asked to produce records by mailing them or bringing them to a local IRS office
- Service Center Examinations
 - Correcting math errors
 - Matching information returns
 - Questioning unallowable items

General tax controversy flowchart



IDR Sample Requests

1. In order to learn the background and activities of the organization as well as to view the facilities:
 - Initial discussion between an organization officer and the Internal Revenue Agent
 - Tour of the organization's facilities
2. In order to ensure the organizational test is met:
 - Governing instruments (Articles of Incorporation, Bylaws, etc.) including any subsequent amendments and name change
3. In order to verify that your activities are exempt activities:
 - Minute books showing any recorded meetings of your governing (Officers, Directors, or Trustees) including committees from mmddyyyy to mmddyyyy
 - Copies of newspapers, newsletters, brochures, magazines, pamphlets and other literature printed
 - Any contracts, leases or agreements to which the organization was a party to in the year under examination may be requested as the need arises

IDR Sample Requests

4. In order to verify the correctness of income, gross receipts, deductions and credits and to reconcile the return to your books:
 - Chart of Accounts
 - If you have an audit report, please provide a copy at appointment
5. Provide a written explanation of all sources of revenue reported on Form 990 filed for year ended mmddyyyy.
6. Please provide copies of all agreements between [taxpayer] and other parties including joint ventures, licensing agreements, leases (in which taxpayer is the lessor), partnerships, S Corporations, and other arrangements generating revenue reported on the Form 990.
7. Provide written internal and/or external analysis of sources of revenue realized during the year of examination and its relationship to the exempt purpose of the organization, as well as any analysis made regarding the reporting sources of income as Unrelated Business Income

IDR Sample Requests

8. Provide copies of all Forms K-1 received by [Taxpayer] reportable on Form 990 filed for year ended mmddyyyy. Provide schedules of the organization's basis in partnerships, joint ventures and S corporations at mmddyyyy.
9. Provide workpapers used to allocate revenue received from Real Property Rentals between those reported on Form 990T and those not included as Unrelated Debt Financed Income.
10. Please provide a written analysis of the sources and nature of Fundraising and Gaming Revenue income reported on the Form 990, along with any analysis prepared in connection with the recognition of Unrelated Business Income from these revenue sources.
11. Please provide copies of all agreements between [taxpayer] and other parties including joint ventures, licensing agreements, leases (in which taxpayer is the lessor), partnerships, S Corporations, and other arrangements generating revenue reported on the Form 990.
12. Provide written internal and/or external analysis of sources of revenue realized during the year of examination and its relationship to the exempt purpose of the organization, as well as any analysis made regarding the reporting sources of income as Unrelated Business Income

IDR enforcement – Consequences of delinquency

- IDR is “delinquent” if due date is missed or if response is incomplete.
- Examiner must discuss reasons for delinquency with taxpayer within 5 days and may grant one informal extension of up to 15 business days from original IDR due date.
- If IDR remains delinquent a mandatory 3-step enforcement process escalates:
 - Delinquency notice
 - Pre-summons letter
 - Summons

Responding to IDRs – Useful Practices

- Communication is key
- Anticipate the government’s interest
- Do not be adversarial
- Explore “information” alternatives that reduce the need for IDRs
- Concentrate on getting the front-end correct
 - If cannot agree on focus or timing – challenge early; do not wait for initiation of enforcement steps
- Track and monitor all facets of IDR process
- Confirm sufficiency of IDR responses
- Elevate when appropriate

Acknowledgement of facts

- Effort should be made to resolve factual differences.
- Publication 5125 provides a process for the examination team to provide a statement of facts related to unagreed issues and secure the taxpayer's *acknowledgment of facts* (AOF)
 - Unclear how factual disputes will be addressed by Compliance (Exam)
 - Not clear how Compliance will deal with relevance issues
 - Exam's skepticism is not evidence
 - IDR enforcement procedures do not apply to the AOF IDR
- Appeals will return case to Compliance if new facts are provided to Appeals

IRS Audits – Adjustments and options

- If the IRS agent finds an issue and wants to assert a tax deficiency, what are the taxpayer’s options?
 - Agree to the proposed deficiency
 - Dispute, in good faith, the proposed deficiency on basis of facts or laws (or both)
 - Ask for technical advice
 - Consider alternative Appeals procedures (occurs prior to the issuance of the 30-day letter)
 - Ask for a 30-day letter—attempt to resolve the issue in Appeals
 - Ask for a 90-day letter so the taxpayer can file a Tax Court petition or pay the tax and file a refund suit in U.S. District Court or Court of Federal Claims

Revenue Agent's Report / 30-Day Letter

- 30-day letter
 - Letter sent by agent proposing adjustments
 - Contains agent's technical arguments and tax calculations
 - Varying degrees of detail and rules supporting the proposed adjustments
 - Taxpayer has 30 days to file a protest with IRS Appeals
- Extension may be available in certain circumstances, but not automatic
 - Request extensions when needed, but obtain written confirmation of any and all extensions granted (if not provided, send confirmation memorializing the discussion and granting of an extension and by whom).
 - If an extension is not granted, file with best available information and supplement (the case will likely be returned to exam by Appeals if new information and documentation is provided that was not previously provided to the revenue agent).

Q&A

Thank you

You may contact one of today's presenters directly:

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