



**Good Fiscal Governance
and Avoiding
(or if that doesn't work,
preparing for) an**

IRS Audit

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As a result of concern for abuse of tax-exempt status, the Internal Revenue Service has again become active in auditing trade associations, which include professional societies such as the Pennsylvania Dental Association and its district and local societies. To assist the tax-exempt organizations with meeting its financial responsibilities, the IRS has also issued standards of good governance for nonprofit corporations (the actual guidance can be found by searching "IRS good governance practices"). In addition, the checklist utilized by IRS Revenue Agents (IRS Form 14114) can be found at www.irs.gov, titled Governance Check Sheet. Examination of the checklist will provide you with insight as to what the IRS is looking for and into when completing an audit. Following these standards and other housekeeping measures suggested in this article will not only prepare a district or local society for a potential audit, but also improve the operation of the organization and make it easier for officers and directors to assume and carry out their duties.

Addressing any IRS audit is going to require reliance on the accuracy and completeness of the district's or local's records and documentation. Following is a checklist of items that should be maintained in the permanent file of the district or local and made available to the officers and directors as needed.

Checklist of records to be maintained

1. Articles of Incorporation (copy of an approved original can be obtained from the Pennsylvania Corporation Bureau)
2. Legal advertising of the filing of the Articles of Incorporation
3. IRS Tax Identification Number Notice and copy of original Form SS-4 Application for a EIN
4. IRS Tax Exemption Letter (a copy or replacement can be obtained from the IRS)
5. Constitution and By-laws showing dates of approval by the society or district
6. Resolutions showing who has authority to sign checks or make electronic payments or transfers and for how much
7. Policies and procedures (Employee Handbook, Organizational procedures)
8. Employee files (resume, original application, salary history, vacation and sick days, accumulated if allowed and those taken)
9. Vendor/Independent Contractor files with evidence supporting their independent contractor status — this is needed for both tax and workers compensation insurance purposes
10. Retirement plan, investment advisor and bank records related to the plan
11. Board Meeting Minutes (should show which board members were present and if any abstained because of a conflict of interest)
12. Board Conflict of Interest Statements (executed)
13. List of Board Members (past and present)
14. Financial Statements if prepared. Even if there are no audited statements, annual financial statements should be given to the district or local's members. This could just be a listing of total receipts (membership dues, etc.) and major expense categories, net income or loss and balance on hand in the bank account. If the district or local society owns depreciable property, the bookkeeping is likely to require the assistance of an outside accountant and require more detail for the tax returns and reports to members.
15. Leases
16. Debt (loans, mortgages, line of credit etc.)
17. Deeds
18. Significant Contracts (service, purchase, sale etc.)
19. Grant Agreements
20. Bank and Investment Statements
21. Insurance Policies (liability, property, fidelity, workers compensation)
22. Tax Returns
23. Invoices
24. Receipts (deposits)
25. Membership applications
26. Membership lists, with office and home addresses, email, fax and even spouses' names if they are routinely included in the district or local's social activities
27. Newsletters if any

While originals of deeds, significant contracts and other important documents should be kept, a copy of the signed documents (tax returns should be first signed and then copied) will suffice for audit and other purposes. The above items should be scanned and saved on a CD-ROM or DVD with a back up put in a safe place such as safety deposit box. Staples, Office Max, Kinkos and other vendors offer scanning services if the district or local society does not own a scanner equal to the task.

A copy of the parliamentary authority referenced in the Bylaws such as *Sturgis* or *Roberts' Rules of Order* should be available for the district or local's parliamentarian.

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In addition to maintaining appropriate records, operations of the district or local will also create certain filing requirements.

Certain items must be filed annually or even quarterly:

1. 1099s should be filed for:

Attorney's fees, independent contractor or employee payments (including speaker fees), director's fees, rents, royalties, other reportable income (such as payments of prizes and awards to non-employees).

In addition to looking for abuse of the tax-exempt status, the IRS is auditing organizations to determine if they improperly classified employees as independent contractors so as to avoid paying payroll taxes. Generally, the determination that someone qualifies as an employee as opposed to an independent contractor requires an analysis of the amount of control the entity has over how and when the individual completes his or her tasks and how much discretion the individual retains. Assistance of a tax advisor should be sought if bookkeeping or other clerical tasks are paid for by the district or local to determine if the person performing those duties should be considered an employee. Any such advice should be in writing and retained.

2. Tax Returns:

File a 990-N if annual gross receipts are normally \$25,000 or less.

Due date is the 15th day of the 5th month after the close of the tax year.

File a 990EZ or 990 if your gross receipts are normally more than \$25,000.

Due date is the 15th day of the 5th month after close of the tax year.

File a 990T if you have more than \$1,000 of unrelated business income such as advertising, and certain rent and royalty payments.

Federal and Pennsylvania Employer Tax Withholding Forms also need to be filed:

- Employer Deposit Statement of Withholding Tax PA-501
- Employer Quarterly Return of Withholding Tax PA-W3
- W-2 Transmittal and Employee W-2 REV-1667
- Tax Account Information Change/Correction Form REV-1705
- Employer's Quarterly Federal Tax Return Form 941
- Employer's Annual Federal Unemployment (FUTA) Tax Return Form 940
- Pennsylvania Unemployment Compensation (PA UC) Quarterly Tax Forms must also be filed. These include:

PA UC-2, Employer's Report for Unemployment Compensation

PA UC-2A, Employer's Quarterly Report for Wages Paid to Each Employee

PA UC-2B, Employer's Report of Employment and Business Changes

The IRS will also be looking to see if officers and directors are benefiting from the district or local through excessive benefit transactions (also known as private inurement) such as favoring insiders with leases of property to or from insiders and excessive compensation. The adoption and enforcement of a Conflicts of Interest Policy will help to avoid such problems. In addition, the IRS may also examine the value of "perks" received by officers and directors while carrying out their functions. These can include lavish meals, tickets to sporting events or other forms of entertainment or trips to extravagant destinations. It is prudent for components to require the submission of a receipt before reimbursing directors or officers for out of pocket expenses.

A more difficult issue the IRS may look at is whether there are particular services being provided to the district or local's members that do not benefit the "common business interest" of the district or local as a whole, such as the sale of specific products that only benefit a portion of the membership. Other activities of concern are advertising and on line job boards. Revenues

from these activities should be reported as unrelated trade or business income (UBIT) on the district or local's Form 990-T.

While the United States Supreme Court struck down prohibitions on trade associations spending money directly for political campaign advertising (*Citizens United v. Federal Election Commission*), it retained the requirements for disclaimers and disclosures; so district and local societies should be sure to comply with the disclaimer and disclosure reporting requirements and should seek the advice of legal counsel before making such expenditures. The prohibition against an organization contributing directly to a candidate was not removed.

Good Governance — Best Practices

There should be segregation of duties so that the persons signing checks are not also the bookkeepers or the ones reconciling the bank accounts. If the check or images are not supplied with the bank statements, arrangements should be made with the bank for the person reconciling the bank statement to obtain them. Alternatively, cancelled

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checks may be able to be reviewed online. There should be internal verification of deposits as well. The person doing the reconciliation should be sufficiently knowledgeable of the activities of the district or local and its vendors to recognize unauthorized payments. Any unusual payments should be brought to the attention of the entire board of directors of the district or local.

The district or local should adopt a written conflicts of interest policy to ensure that members, officers and directors do not receive excess benefits or unreasonable compensation for services provide. The PDA and the IRS have example policy forms for adoption.

A written whistleblower policy should also be adopted to encourage reporting of wrongdoing or waste without recrimination. Doing this ensures that the district or local's board of directors are informed by employees or members of activities that are a violation of the bylaws, conflicts of interest policy and any other policies or even possible criminal acts or violations of the Internal Revenue Code. A sample whistleblower policy is available upon request from PDA.

The district or local should develop a procedure to train its directors and officers about the operations of the organization as well the responsibilities of their office. As volunteer organizations, a lot of reliance may be placed on the limited staff (executive director) or outside consultants (bookkeepers, attorneys, part-time membership coordinator...). Reliance on these individuals without accurate understanding of the operations by the directors or officers creates an environment ripe for abuse or neglect.

In the past, record retention was sometimes difficult and even costly due to demands upon staff and space. Today, with the use of electronic media most PDA district and local society records could be included in one CD-ROM, or at least one DVD, which can contain thousands of documents. However, many records can be safely discarded after a period of years where space does become a problem. Following is a suggested abbreviated document retention and destruction policy for consideration by a district or local society:

- Tax records and returns for at least 7 years
- Leases, deeds, significant contracts and other such documents permanently
- Other contracts, at least 4 years after expiration of the contract
- Personnel records at least 7 years
- Workmen's compensation and other insurance policies permanently
- Financial statements and underlying accounting journals and ledgers (cash receipts and disbursements, general ledger) permanently
- Minutes permanently

You should select a certain month of the year to accomplish your record

destruction. At that time, all items that have exceeded their retention period should be destroyed. For physical records and documentation, shredding is the preferred practice. For electronic records and files, you should consult with your IT provider to determine the appropriate way of destroying the records. Recognize merely deleting a file or email and removing it from your trash bin will not remove the item from your computer. In the event you receive a lawsuit or learn that the filing of one is imminent, you should immediately stop the destruction of any and all records that have the potential of being relevant to the litigation.

Alternative record retention policies are available upon request from PDA or organizations such as the Pennsylvania Institute of Certified Public Accountants.

Hopefully, the foregoing will be helpful in enabling your component to refine its operations and be prepared should the IRS come knocking. Should a district or local society be contacted by the IRS, PDA's CEO should be informed, as PDA may have information on resolving issues that have been raised before and successfully resolved by trade associations or even other PDA component societies.

About The Authors

Thomas J. Weber, Esq. (a shareholder in the Harrisburg law firm Goldberg Katzman, P.C.) serves as general counsel to the PDA and PDAIS. He devotes a substantial portion of his practice to dental-related matters and frequently writes and lectures on legal issues pertinent to dentists.

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