

Author Spotlight: Preparing for an Audit

Host: Ted Hart

Guest: Victoria Bjorklund – Retired Partner, Simpson Thacher & Bartlett LLP

Announcer: Welcome to the CAF America Radio Network, a production of the Charities Aid Foundation of America. As the leader in global giving, CAF America offers more than 20 years of experience and expertise to corporations, foundations and individuals who wish to give internationally and with enhanced due diligence in the United States. Through its industry-leading Grant Management Programs and Philanthropic Advisory Services, CAF America helps donors amplify their impact.

This show is dedicated to these donors and the charities they support. CAF America is uniquely positioned to serve as the bridge between these important partners and transforms vision into meaningful action. Guest on the CAF America Radio Network are leaders in their field who share tips for success and stories that inspire. Our host is Ted Hart, the CEO of the Charities Aid Foundation of America. This is a live call-in show. Add your voice by calling 914-338-0855. After the show, you can find all of our podcasts at CAFamerica.org. Don't forget to dial 914-338-0855. Now, welcome the host of the CAF America Radio Network, Ted Hart.

Ted Hart: Welcome here to the latest edition of the CAF America Radio Network. It is my pleasure today to introduce you to another author from our new book *Cross-Border Giving: A Legal and Practical Guide*. With the release of this book, we're very excited to bring you a series of conversations with our esteemed contributing authors and today Victoria Bjorklund, retired partner at Simpson Thacher & Bartlett, is our guest.

She has founded and headed the Firm's Exempt Organizations Group. Victoria is a former chair of the ABA tax section committee on exempt organization and of its Subcommittee on International Philanthropy. She is co-author of *New York Non-Profit Law and Practice 2015* and annual supplements. She's also taught the law of non-profits at Harvard Law School for eight years ending at just last year. Welcome here to the CAF America Radio Network, Victoria Bjorklund.

Victoria Bjorklund: Thank you so much, Ted. It's a pleasure to be here with you today, particularly on this topic.

Ted: Particularly on this topic, which is so important. I was just about to say it's such a pleasure for us to have you as an author in this important book. Your topic is preparing for an audit, which is not maybe something that everyone looks forward to but nonetheless must be prepared for. Before we get into our conversation today, could you just share a little bit more about your professional background that brings you to be our chosen expert on this topic?

Victoria: Well, Ted, I worked with non-profits for several years being employed by a non-profit before I went to law school. I began my work with International Friends of Organizations in 1982 when my partner Cyrus Vance return to Simpson Thacher from the US State Department. He had been Secretary of State and he asked me to work with him on an early Friends of Organization in South Africa, FODSA, which was Friends of the Organization for Democracy in South Africa. That was a very challenging time because of apartheid, and therefore working through the friends rules with the former Secretary of State and the people he brought to the table was extremely enlightening for me.

In 1988, I began working with Médecins Sans Frontières, which has become one of the largest and best-known Friends of Organizations. I've also worked with the Friends of the Louvre Museum and the Louvre

Endowment in France as well as with Friends of Fondation de France, not to mention CAF America of course and dozens of other Friends of Organizations.

I've worked with dozens over the years and I'm very focused on the challenges, but also the wonderful opportunities that International grantmakers bring for American donors to be giving internationally. So important around the world, especially in these times where government is cutting back. In that context, I think all of them have to be aware about the audit possibility and the audit need to be prepared.

Ted: I hope you take a rightful pride in the fact that-- I think it's fair to say that CAF America would not be able to be the organization that is the trusted voice for international grantmaking in the United States that we are today if it were not for Victoria Bjorklund in the beginning of this organization, and for many, many years guiding us, guiding our protocol, guiding the work that we do. Of course, part of that is making sure that we ourselves are prepared for audit.

Let's put this topic on the table because in reality, should an organization which engages in global grantmaking really expect to be audited? How likely is this and how important is this topic?

Victoria: Ted, an audit is inevitable in the international context. It's inevitable. It may not be by the party the charity expects but it's going to happen at some point or another. It can happen by a US government agency such as the IRS or a non-US government agency such as the UK charity commission or it could be an internal audit that's organized by the organization's board of directors or it could be an audit by an international organization such as WHO. Frankly, the most common audit is one that's done by a funder and many, many, many funders do audits of international grants.

Ted: Rightfully so, right? The money that is being used that is going into another country being used by another organization is a very big deal, and there's a lot of regulations and even internal protocols that must be followed. Are our audits strictly financial? Are they just looking at how money is spent or are there other aspects to audit?

Victoria: The definition from Merriam-Webster of an audit is the formal examination of an organization's accounts or financial situation or a methodical examination and review. In my experience, audits can be either financial or they could be of grantmaking procedures, operations, practices and particularly how a grant is spent by an organization, so a grant-specific audit.

I will tell you, I've had experiences, for example, overseas where cultural issues have arisen. For example, one of my clients made a grant into an Asian country where it was customary for the executive director to honor his family members by buying them color televisions out of the grant money. Now, that may have been the cultural norm in that country, but definitely was a violation of the grant terms and we had to get that grant corrected by getting those TV sets back and getting the funds restored into the grant.

Ted: Well, that's a frightening example. Our audit make it up as you go along or are there some norms or some guidelines, and if so, who is setting the norms and guidelines? Is this something that the IRS itself gets involved with or not? Where do you find some of the norms that you might use to prepare for audit?

Victoria: Well, the IRS rules are set out for private foundations under the expenditure responsibility, Treasury Regulations, and I don't mean to get too technical. For people who are not familiar with those, those are under Code Section 4945 and those regulations spell out procedures. There are also rulings

that spell out procedures and if you comply with those revenue rulings and Treasury regulations, even if your organization is not a private foundation, you should certainly meet the IRS requirements.

In addition to those requirements, some funders have very specific rules, particularly about procedures and application of funds. Of course, you have to be very familiar with the fine print in any grantmaking contract or agreement you are signing and you need to comply with those requirements for every grant that you accept under those contracts.

Ted: In your chapter, you referenced IRS's FY 2016 priorities letter in terms of adhering to legal guidelines for exempt organizations. What is that and why do you point to that as an important place to look for audit guides?

Victoria: Every year, the IRS publishes a priorities letter for the year ahead. At this point, because of constrained resources, they are generally identifying five key areas of focus for the year ahead for audit activity. The letter for 2017, which was published in 2016, highlighted the topic of international. Specifically, the IRS said that they would be auditing issues that include oversight of funds spent outside of the United States, including funds spent on potential terrorist activities, exempt organizations operating as foreign conduits and report a foreign bank and financial accounts the new FBAR rules for charities and other organizations that maintain foreign financial accounts or bank accounts overseas in excess of \$10,000.

We see the foreign topic coming up periodically but it was of great interest to me that those particular subsets of the international grantmaking field were identified explicitly by the IRS as one of their five areas of focus, and presumably, those audits are going on now.

Ted: Right. These are topic areas that are easily identifiable for the IRS either from a charities 990 report or as you mentioned the FBAR report are two areas that they can go to identify potential leads in the kinds of organizations that might meet the standards that they're looking for in their audit priorities. Is that correct?

Victoria: That's correct. In addition, the IRS maintains referral vehicles. Any individual or company can write a letter to the IRS and send it in, making a referral, saying, "I think this organization is doing something wrong and this is what I think it is." You can make those referrals anonymously. The IRS has certainly indicated that they take referrals seriously and use them to open audits.

In addition, it is not uncommon for the IRS to see a news report about possible improper activity and to audit based on a news report that they have seen. Finally, there are criminal divisions inside the IRS. They work with their counterparts around the world. We have seen evidence in recent years that the foreign government officials may be making a referral to the IRS through those non-US offices, particularly in the areas of possible terrorist financing. All of those are additional ways that the IRS may decide to launch an audit.

Ted: Now, one of the areas in the priority letter that you reference is an exempt organization operating as a foreign conduit. What does that mean in plain English?

Victoria: A lot of people think that the word conduit sounds frictionless and happy and positive. In the area of international grantmaking, conduit is a dirty word. Why is it a dirty word? Well, if you're a public charity and you are accepting tax-deductible contributions from US taxpayers, you are required as the

US recipient to exercise control and discretion over those funds in granting them to a foreign organization whose project you have pre-approved.

If you do not follow the required procedures and just shoot the money out, that is acting as a conduit and a consequence to your donors will be loss of their charitable deductions in the United States, because it's as if they are making a grant directly to the foreign charity. Of course, that is not deductible under US law because donors can only deduct grants made to charities formed under the laws of the United States.

If you're a private foundation and you give to a conduit, then you have a problem because you should have exercised expenditure responsibility under Code Section 4945, which I previously referenced. That is similarly a problem for you because you have not followed the proper procedure and you can be subject to an expenditure responsibility penalty. As a private foundation grantor, you want your US charitable recipient to follow the proper grantmaking procedures so that you do not have a conduit gift.

Ted: Presumably, a charity that serves as a conduit could lose its status.

Victoria: It could lose its status. Sometimes, we see that the IRS actually offers both of those reasons in penalty actions. We saw in 2015 in a letter of revocation, it was the final adverse determination by the IRS revoking exemption of a Friends of Organization because the IRS determined that more than insubstantial part of the organization's activities were not in further and serve exempt purposes because they weren't operated exclusively for exempt purposes.

They weren't doing their assigned role of managing the grantmaking properly and following the requirements. The IRS also proffered a secondary rationale for its actions, namely, that the contributions wouldn't be deductible because the organization failed to exercise control and discretion over donated funds, and therefore was operated as conduits. That's a real-life example.

Ted: Someone who says, "I'm making a contribution to this charity in some country outside of the United States. I'm giving through a pass-through organization." You know you've got trouble.

Victoria: Yes. When I have been asked by clients who may be making \$10,000 or \$1 million grants, and they're asking me to check out the procedures of the recipient charity, if I see that charity is just a pass-through or conduit to the foreign organization, I advise against making that grant.

Ted: Making that grant. Well, Victoria, we're going to take a very quick break and when we come back, the IRS is knocking on the door, you receive the initiation letter or the Information Document Request, the IDR from the IRS, and what do you do. We'll be right back.

Voiceover: Remember, our podcast and archives are always available 24 hours a day at cafamerica.org. If you're listening today, our phone lines are open. Call in and ask a question by dialing 914-338-0855. Now, back to the CAF America Radio Network and our host, Ted Hart.

Ted: We're back here live with Victoria Bjorklund who is a retired partner of Simpson Thacher & Bartlett, and more importantly for our discussion today is the author of a chapter in our new book, *Cross-Border Giving*. I'll also want to note that we are live casting today on [facebook.com/cafamerica](https://www.facebook.com/cafamerica). Victoria, we're back and the IRS is knocking on the door or you opened your mail and you've got an Information Document Request. What is it and what do you do?

Victoria: Well, this is the way that the IRS initiates an audit. I will tell you that it is often true that you will get a courtesy call telling you the letter is coming and you should be on the lookout for it. Those kind of calls initiate great concern, but you want to look at that letter very carefully.

As soon as it comes in, I have been astonished on a few occasions where people got such a letter from an IRS initiating an audit and they just tucked it aside and said, "Well, I'll get to it when I have time." No, no, no, that is not the thing to do. First, you must review that letter promptly and carefully and you need to assess what kind of review is the IRS launching, and based on that, you will get some guidance on who you need to get involved.

Secondly, you need to focus on when the reply is due. Sometimes there are delays between the time when the IRS issues the letter and when it gets processed through the system and actually mailed to you and it could be a short amount of time. If that is the case, you need to call right away and get an extension. That's why it's important to see what review is being done. There are four different kinds and when the reply is due.

Ted: What are the kinds of reviews that are likely or customary?

Victoria: There are four kinds: a compliance review, a compliance check, a correspondence audit or a field examination. I mentioned them in that order because that is the order of seriousness. Really, the correspondence audit and the field examination, only those two are the true audits. The other two, the compliance review and the compliance check, are generally done by mail and they're looking only at a limited aspect of your operations. Something caught their eye for example on a 990 or it didn't look to be consistent in the way you reported it, and they just have a simple check that they want to double-check a particular point with you. Those are very limited.

A correspondence audit or a field examinations are the much more detailed and complex audits, and the field examination is the most complex at all. That means that an IRS agent or multiple agents are going to move in with your charitable organization. You're actually required to give them office space and access to your documents on site.

Ted: What sorts of documents would likely be called upon or that you need to, I'm guessing, provide ready access for the IRS in whatever level of compliance. What sorts of documents might they be looking for?

Victoria: Every audit begins with an IDR, that's an Information Document Request for the certificate of incorporation, the bylaws, usually your application for exemption on form 1023 and then copy of your IRS form 990 or 990-PF for each year that's going to be under audit. One of the really important things to look for when you get the initiating letter is what years are under audit, and you should only be providing information on the year or years under audit. The IRS will follow specific procedures if they want to add an additional year or two years to the audit, but you never want to provide information for a year that isn't open.

Ted: I would imagine that part of preparing for an audit is to always be prepared by knowing where these documents are in the first place and having ready access to those documents.

Victoria: Absolutely. Every grant that an international grantmaker makes should be accompanied by a grantmaking checklist. In my chapter in the book, I give examples of what you need. I won't list them all here now; but I can't tell you how many times I've gotten thank you calls from clients saying, "It was so

easy to go through this audit because I already had each document on hand and in an electronic file, and I was able just to provide it to the IRS audit agent. I didn't even need to get an outside lawyer or accountant involved." Typically, those are going to be the grant and the reports back and the budget and the application.

Ted: It occurs to me that as you look through this, part of what you mentioned is that resolutions and/or meeting minutes, executed written grant award agreements are also part of being prepared. It also requires organizations, our listeners today, to really question how well organized are they in their grantmaking program because if you don't regularly keep this information, you're certainly not going to be prepared for audit.

Victoria: No, it's much more expensive to have to go and find all the documents after the fact than it is to just have a procedure after every board meeting or after every unanimous consent when a grant is approved. Then you just drop the document such as the resolution and the grant award agreement into the electronic file.

Ted: What would be the role of advisors or legal counsel in both preparing for audit but also in actually being part of an audit, participating in that IRS audit?

Victoria: Sometimes, audits are going to be very complicated or field examination in particular, and they're going to ask for a lot of internal documents. You may need legal counsel to identify and redact privileged documents. Which point your counsel is going to need to prepare a privilege log and date stamp the pages that you are producing. This is particularly the case where there are numerous IDRs requesting internal legal memos where you got legal advice on perhaps how a particular grant was going to be made. Some of that is privileged attorney-client communication and it's not going to be given to the IRS.

Ted: Is that a wise position to take or is that a standard position to take?

Victoria: That's a standard position to take in a complex audit situation. I've had audits that have gone on for multiple years. I once had a four-year audit and we had hundreds of IDRs. I'm very proud to say that that audit was closed with no change letter, meaning that the charity did not have to change any procedures and had no penalties, but we did have a complicated organization that had gotten many legal memos in addition to a private letter ruling. There was a lot of attorney-client communication that was not meant to be widely dispersed.

Ted: Is it possible that you don't hit it off with the agent or you believe that for whatever reason due to comments or whatever the agent could be biased. Do you have any control over who your agent might be or any input into that?

Victoria: You don't have any control over your audit agent. If you show the merits of your organization's position and describe how you comply with the law and the agents still disagrees, we always recommend that you ask to speak to the audit agent supervisor to explain what the problem is. That's the role of the supervisor and sometimes they intervene. If they don't, then you can ask to have them write up their proposed position and you may need to apply for technical advice to resolve an issue, and you file an internal appeal with the Appeals Division. I've had to do that at times and I've gotten favorable results from that internal procedure.

Ted: What happens if someone didn't buy this book, they didn't read your chapter, they didn't listen to Victoria Bjorklund and they're found to be in violation?

Victoria: Well, often that comes up when you bring in your audit or you return preparer and they see what the problem is, and they tell the charity you were wrong. What we recommend is that the charity immediately proactively adopt improved policies and procedures and say to the IRS, "We realized we were not in compliance with this revenue ruling or this regulation, and here are the policies that we've adopted. Here are the procedures that we've adopted."

The real goal of the audit is to have the charity in compliance. Often, the auditor is very happy to see that and will write up the audit saying that the charity acknowledges the error and has corrected the procedures.

Ted: Victoria, what do you think about this book? How would you recommend this in the work that you do or the work that you advise?

Victoria: I've recommended this book to many people who seek guidance from me on international grantmaking, many of them from overseas and many of them here in the US eager to help. The reason that I recommend the book is because all of the advice on giving methods is collected in one place, not in different law review articles or bar lectures. Second, the appendixes contain really valuable rulings and sample documents, again, collected in one place, so you don't have to go around trying to find those documents. It's a very practical book and well worth the investment.

Ted: Victoria Bjorklund, thank you so much for not only writing this chapter, but being my guest today here on the CAF America Radio Network in the Author Spotlight. Victoria, thank you.

Victoria: My pleasure. I've really enjoyed being with you.

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