



December 2020

# HIGHER EDUCATION

## IRS And Education Could Better Address Risks Associated with Some For-Profit College Conversions

Accessible Version

# GAO Highlights

Highlights of [GAO-21-89](#), a report to congressional requesters

## Why GAO Did This Study

A for-profit college may convert to nonprofit status for a variety of reasons, such as wanting to align its status and mission. However, in some cases, former owners or other insiders could improperly benefit from the conversion, which is impermissible under the Internal Revenue Code and Higher Education Act of 1965, as amended.

GAO was asked to examine for-profit college conversions. This report reviews what is known about insider involvement in conversions and to what extent IRS and Education identify and respond to the risk of improper benefit. GAO identified converted for-profit colleges and reviewed their public IRS filings. GAO also examined IRS and Education processes for overseeing conversions, interviewed agency officials, and reviewed federal laws, regulations and agency guidance. GAO selected five case study colleges based on certain risk factors, obtained information from college officials, and reviewed their audited financial statements. In three cases, GAO also reviewed Education case files. Because of the focus on IRS and Education oversight, GAO did not audit any college in this review to determine whether its conversion improperly benefitted insiders.

## What GAO Recommends

GAO is making three recommendations, including that IRS assess and improve conversion application reviews and that Education develop and implement procedures to monitor newly converted colleges. IRS said it will assess its review process and will evaluate GAO's other recommendation, as discussed in the report. Education agreed with GAO's recommendation.

View [GAO-21-89](#). For more information, contact Melissa Emrey-Arras at (617) 788-0534 or [emreyarrasm@gao.gov](mailto:emreyarrasm@gao.gov).

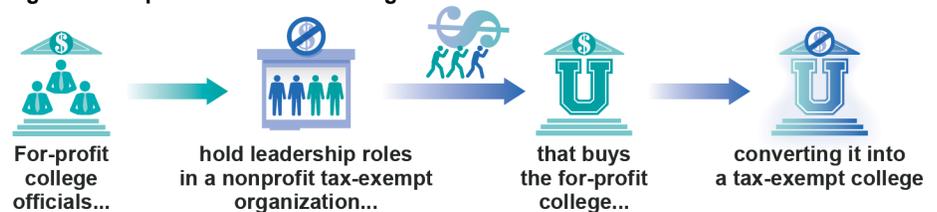
## HIGHER EDUCATION

### IRS and Education Could Better Address Risks Associated with Some For-Profit College Conversions

## What GAO Found

GAO identified 59 for-profit college conversions that occurred from January 2011 through August 2020, almost all of which involved the college's sale to a tax-exempt organization. In about one-third of the conversions, GAO found that former owners or other officials were insiders to the conversion—for example, by creating the tax-exempt organization that purchased the college or retaining the presidency of the college after its sale (see figure). While leadership continuity can benefit a college, insider involvement in a conversion poses a risk that insiders may improperly benefit—for example, by influencing the tax-exempt purchaser to pay more for the college than it is worth. Once a conversion has ended a college's for-profit ownership and transferred ownership to an organization the Internal Revenue Service (IRS) recognizes as tax-exempt, the college must seek Department of Education (Education) approval to participate in federal student aid programs as a nonprofit college. Since January 2011, Education has approved 35 colleges as nonprofit colleges and denied two; nine are under review and 13 closed prior to Education reaching a decision.

**Figure: Example of a For-Profit College Conversion with Officials in Insider Roles**



Source: GAO analysis of Internal Revenue Service (IRS) documents. | GAO-21-89

IRS guidance directs staff to closely scrutinize whether significant transactions with insiders reported by an applicant for tax-exempt status will exceed fair-market value and improperly benefit insiders. If an application contains insufficient information to make that assessment, guidance says that staff may need to request additional information. In two of 11 planned or final conversions involving insiders that were disclosed in an application, GAO found that IRS approved the application without certain information, such as the college's planned purchase price or an appraisal report estimating the college's value. Without such information, IRS staff could not assess whether the price was inflated to improperly benefit insiders, which would be grounds to deny the application. If IRS staff do not consistently apply guidance, they may miss indications of improper benefit.

Education has strengthened its reviews of for-profit college applications for nonprofit status, but it does not monitor newly converted colleges to assess ongoing risk of improper benefit. In two of three cases GAO reviewed in depth, college financial statements disclosed transactions with insiders that could indicate the risk of improper benefit. Education officials agreed that they could assess this risk through its audited financial statement review process and could develop procedures to do so. Until Education develops and implements such procedures for new conversions, potential improper benefit may go undetected.

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December 31, 2020

The Honorable Robert “Bobby” Scott  
Chairman  
Committee on Education and Labor  
House of Representatives

The Honorable Patty Murray  
Ranking Member  
Committee on Health, Education, Labor, and Pensions  
United States Senate

The Honorable Richard Durbin  
United States Senate

The Honorable Margaret Hassan  
United States Senate

In recent years, a number of for-profit colleges have sought nonprofit college status. To become a tax-exempt nonprofit college, a for-profit college must be recognized as tax-exempt by the Internal Revenue Service (IRS) and be approved as a nonprofit college by the Department of Education (Education).<sup>1</sup> Some for-profit colleges may seek a conversion to better align their status with the mission of the college, to gain eligibility for federal research grants, or to enable students to apply for certain state grants.<sup>2</sup> Others may seek the reputational benefits they believe are associated with the public’s positive perception of nonprofit colleges. In addition, some colleges may convert to reduce their tax

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<sup>1</sup>Requirements for exemption from federal taxation are established in the Internal Revenue Code and requirements for recognition as a nonprofit college for federal student aid purposes are established in the Higher Education Act of 1965, as amended (Higher Education Act). See Pub. L. No. 89-329, tit. IV, 79 Stat. 1219, 1232-54 (codified as amended at 20 U.S.C. §§ 1070-1099d).

<sup>2</sup>In this report, we use the term for-profit college conversion to refer to a college’s transition from for-profit ownership to ownership by a nonprofit organization recognized by IRS as tax-exempt. The college must separately apply to Education for nonprofit college status. See 20 U.S.C. §§ 1003(13) and 1094(a).

burden or to avoid limits on federal student aid programs that apply only to for-profit colleges.<sup>3</sup>

In some conversions, the former owner and other executives associated with the previously for-profit college have no role in the new nonprofit college. For example, the owner of a for-profit college who wants to retire may sell the college to an existing nonprofit college and have no continuing association with the college. In other conversions, the for-profit college's former owners or their family members, executives, or board members may continue to play leadership roles in the newly nonprofit college.<sup>4</sup> IRS guidance refers to such individuals with influence over a nonprofit tax-exempt organization, like a college, as insiders to the organization.<sup>5</sup> In the case of a for-profit college conversion, the ongoing involvement of insiders familiar with a college's history and operations can benefit the college, for instance, by promoting continuity and stability. However, there is also a risk that such individuals could make decisions on behalf of the newly nonprofit college to improperly benefit themselves financially at the expense of the college's nonprofit mission. Doing so would be impermissible under the Internal Revenue Code and the Higher Education Act, which require that a nonprofit college operate exclusively for tax-exempt purposes and prohibit any of its earnings from being used to improperly benefit private individuals.<sup>6</sup> For example, these statutory requirements make it impermissible for a former for-profit college owner or executive who holds a leadership role in the new nonprofit college to steer new college contracts toward a business that person controls for an

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<sup>3</sup>For this report, we define federal student aid programs as financial aid programs authorized under Title IV of the Higher Education Act. These include the William D. Ford Federal Direct Loan, the Federal Pell Grant, and the Federal Work-Study programs.

<sup>4</sup>Nonprofit and for-profit colleges generally have governing bodies or boards that consist of an appointed or elected group of individuals responsible for ensuring that management decisions are in the best interest of the college and its various stakeholders.

<sup>5</sup>According to IRS officials, the term "insider" is derived from the definition of "private shareholders and individuals" in statute and regulations and as interpreted by judicial decisions. Treasury Regulations define the term "private shareholder or individual" in section 501 of the Internal Revenue Code to refer to "persons having a personal and private interest in the activities of the organization." See 26 C.F.R. § 1.501(a)-1(c). Courts have interpreted this term to mean an insider of the charity. See *United Cancer Council, Inc. v. Comm'r*, 165 F.3d 1173, 1176 (7th Cir. 1999). If the net earnings of an organization inure in whole or in part to the benefit of insiders, the organization is not operated exclusively for one or more tax-exempt purposes.

<sup>6</sup>See 20 U.S.C. § 1003(13) and 26 U.S.C. § 501(c)(3).

inflated price. You asked us to review issues related to for-profit college conversions to nonprofit status.

This study examines (1) what is known about insider involvement in for-profit college conversions, (2) to what extent IRS identifies and responds to the risk of improper benefit associated with for-profit colleges that apply for and obtain tax-exempt status, and (3) to what extent Education identifies and responds to the risk of improper benefit associated with for-profit colleges that apply for nonprofit status, and those that successfully obtain nonprofit status, in federal student aid programs.

To describe what is known about insider involvement in for-profit college conversions, we used data from Education to identify all for-profit colleges that applied to Education for nonprofit college status (generally after receiving IRS tax-exempt status) and whose conversion transactions took place from January 2011 through August 2020.<sup>7</sup> We also reviewed data on federal student aid provided to these colleges in the 2018-2019 award year, the most recent year available at the time of our review. We assessed the reliability of these data by reviewing the completeness of the list of colleges and interviewing knowledgeable agency officials about both datasets. We found the data to be reliable for the purpose of counting for-profit college conversions and describing college funding. We also analyzed publicly available IRS applications for tax-exempt status

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<sup>7</sup>We used Education data provided in April 2019 to identify all colleges that (1) had undergone a conversion transaction and (2) applied to Education to be recognized as a nonprofit college or to merge with an existing nonprofit college, regardless of the status or outcome of the application. While a college may submit an application for nonprofit college status to Education before it has undergone a conversion transaction and received tax-exempt status from IRS, it must already have tax-exempt status for Education to consider the application. We used Education data because IRS did not have historical data on for-profit colleges that had obtained tax-exempt status. For-profit colleges first became eligible to participate in federal student aid programs in 1972. The data Education provided in April 2019 indicated that the first for-profit college applications for nonprofit college status in their records were from November 2010, and that the conversion transactions for these colleges occurred in January 2011. However, in June 2020 Education officials identified a for-profit college conversion that occurred in 1995. Because we were completing our audit work, we did not include this 1995 conversion in the scope of our review. Education officials confirmed that no additional colleges had completed their conversion transactions and applied to it for nonprofit college status as of August 2020. Therefore, the universe of for-profit college conversions included in our review spans January 2011 through August 2020. Each college in this universe corresponds with an institution of higher education that participated in federal student aid programs under a unique Office of Postsecondary Education identification number (OPEID). Some colleges may have multiple locations under one OPEID. In other cases, a group of colleges under common ownership may have multiple OPEIDs.

and annual IRS filings, to determine whether for-profit college officials were insiders to the conversions we identified. Insiders are defined by the IRS as private shareholders or individuals with a personal and private interest in a tax-exempt organization's activities who, through a special relationship with the organization, are able to influence its financial decisions. To identify the involvement of insiders before and upon conclusion of each conversion transaction, we used information disclosed in public IRS filings and other sources, as needed, to assess whether (1) for-profit college owners, their family members, board members, or executives held board or executive roles in the college's nonprofit purchaser before the conversion transaction or (2) a for-profit college owner with a more than 35 percent ownership stake in the college assumed a nonprofit leadership role immediately after the transaction.<sup>8</sup> We then analyzed Education data on the financial condition of each college for the year before, the day of, and the year after its conversion transaction to identify potential effects of the conversion on the financial condition of each college. We assessed the reliability of these data by reviewing related documentation, interviewing knowledgeable agency officials, and conducting manual data testing. We found the data to be reliable for the purpose of describing the financial condition of colleges over this period.

We also selected for further review a judgmental, risk-based sample of five case study colleges whose conversions involved for-profit college

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<sup>8</sup>IRS asks tax-exempt organizations to report whether board members, executives, or other insiders have family or business relationships with each other or business relationships with the organization. Further, IRS asks applicants for tax-exempt status to disclose transactions with any organization in which an insider owns a more than 35 percent ownership stake. Given the complexity of some conversions and possible limitations of the available information associated with them, we may not have identified all cases in which for-profit college officials were insiders to the tax-exempt organization that purchased the college. Any tax-exempt organization, including a college, is prohibited from using its earnings to improperly benefit its founders, members of its board, their families, or anyone else fairly described as an insider. The test is functional and looks to the reality of control rather than to the insider's place in a formal table of organization. See 26 C.F.R. § 1.501(a)-1(c) and *United Cancer Council, Inc. v. Comm'r*, 165 F.3d 1173, 1176 (7th Cir. 1999).

officials as insiders in either of the ways described above.<sup>9</sup> We reviewed each case study college's audited financial statements and Education data on the colleges' financial conditions from the most recent year available. We also requested information from college officials on the involvement of insiders in their conversion, its reported benefits, potential risks, and safeguards implemented to mitigate those risks. For comparison, we randomly selected a group of five colleges whose conversions did not involve insiders and reviewed the colleges' audited financial statements and Education data on their financial conditions from the most recent year available as well. The results of our case studies are not generalizable to all for-profit colleges that have sought or obtained nonprofit status; rather, they are illustrative of the types of potential benefits and risks a for-profit college conversion may pose and the possible financial implications of such conversions.

To examine the extent to which IRS identifies and responds to the risk of improper benefit associated with for-profit colleges that seek and obtain tax-exempt status, we reviewed relevant federal laws and regulations, and IRS guidance to staff on reviewing applications for tax-exempt status. We also interviewed IRS staff about the agency's processes for: (1) reviewing applications for tax-exempt status, particularly with respect to organizations with a for-profit history; (2) monitoring tax-exempt organizations' compliance with relevant requirements; and (3) selecting annual IRS filings submitted by tax-exempt organizations for examination (or audit).<sup>10</sup> We reviewed publicly available applications for tax-exempt status to identify applications that disclosed plans to purchase a for-profit

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<sup>9</sup>When making our five case study selections, we also considered risk factors in two additional areas: Education's evaluation of the colleges' financial condition for the year before and year of the conversion transaction and the amount of federal student aid funding the colleges received in the year before their conversion transaction. We selected colleges for review that possessed one or both of the risk factors we identified in these areas: (1) declining financial condition following the college's conversion, and (2) relatively high level of federal student aid funding in the year before conversion, compared to other colleges in our universe.

<sup>10</sup>An IRS examination is a review of a tax-exempt organization's books and records to determine whether the organization is operating in accordance with its exempt purpose. We use audit throughout this report, which is another term for an examination.

college from insiders.<sup>11</sup> We then assessed IRS staff reviews of these applications against IRS staff guidance. We also assessed IRS oversight of its approval process against federal internal control standards for reviewing procedures to address risk. We further assessed IRS efforts to identify previously for-profit colleges for oversight purposes against federal internal control standards for using quality information to make decisions.<sup>12</sup> In recognition of taxpayer privacy protections, we did not interview IRS officials about any tax-exempt organization in our review nor did we review nonpublic documentation associated with an application for tax-exempt status or any audit for any tax-exempt organization in our review. Further, because we focused on the steps IRS takes to identify and respond to the risk of improper benefit, we did not conduct an audit of any tax-exempt organization in our review to determine whether insiders improperly benefitted from any conversion, nor did we assess the outcome of any decision IRS reached with respect to any application in our review.

To examine the extent to which Education identifies and responds to the risk of improper benefit associated with for-profit college conversions, we reviewed relevant federal laws and regulations, and agency procedures for reviewing applications for nonprofit college status and monitoring colleges after they obtain nonprofit college status, and interviewed Education officials about these processes. We reviewed Education's case files for the three case study colleges whose applications had been approved by Education when we selected our case study colleges.<sup>13</sup> We also spoke with Education officials about their decisions regarding these colleges and their post-approval monitoring of the colleges. Because we focused on the steps that Education takes to identify and respond to the risk of improper benefit, we did not conduct an audit of any college in our review to determine whether insiders improperly benefitted from any

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<sup>11</sup>Specifically, we reviewed all available approved IRS applications for tax-exempt status associated with for-profit colleges that applied to Education for nonprofit college status. We identified those applications that disclosed plans to acquire a for-profit college from insiders and assessed IRS's review of those applications. Because this objective focused on IRS's review process, our analysis included any application that disclosed plans to purchase a for-profit college from insiders, including any in which the nonprofit organization did not subsequently purchase the for-profit college as planned.

<sup>12</sup>GAO, *Standards for Internal Control in the Federal Government*, [GAO-14-704G](#) (Washington, D.C.: September 2014).

<sup>13</sup>The two other case study colleges had nonprofit applications pending with Education when we selected our cases.

conversion, nor did we assess the outcome of any decision Education reached with respect to any college's application for nonprofit status in our review. In addition, we reviewed college websites to understand how colleges advertised their status while their applications for nonprofit college status were pending with Education. We assessed Education's post-approval monitoring practices against federal internal control standards for designing control activities to achieve objectives and respond to risks.<sup>14</sup> For further details on our scope and methodology, see appendix I.

We conducted this performance audit from September 2018 to December 2020 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Background

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### Methods of Conversion

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To achieve nonprofit college status, a for-profit college must be recognized as tax-exempt by IRS and separately obtain approval from Education to participate in federal student aid programs as a nonprofit college.<sup>15</sup> There are several methods by which a for-profit college can obtain tax-exempt status from IRS.<sup>16</sup> For example, as noted in IRS application guidelines, a for-profit entity, such as a college, may reincorporate as a nonprofit organization at the state level and apply directly to IRS for federal tax-exempt status<sup>17</sup> (see figure 1).

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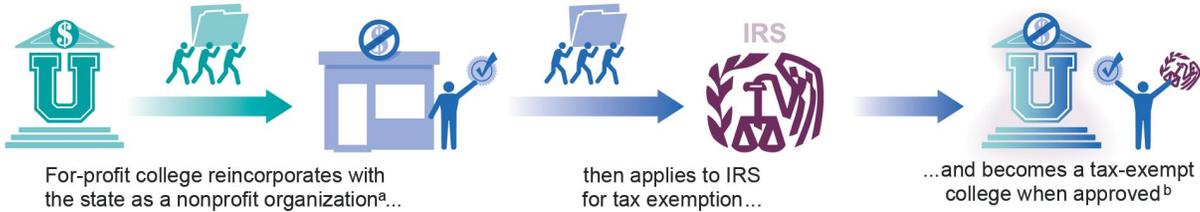
<sup>14</sup> [GAO-14-704G](#).

<sup>15</sup>In this report, we use the term nonprofit college to refer to an institution of higher education that has been approved by Education to participate in federal student aid programs as a nonprofit college.

<sup>16</sup>A college must meet the requirements of § 501(c)(3) of the Internal Revenue Code to be recognized as tax-exempt, regardless of its method of conversion.

<sup>17</sup>Specifically, an organization created under state law for nonprofit purposes may apply to IRS for tax-exempt status.

**Figure 1: Example of a For-Profit College Reincorporating as a Nonprofit Organization and Applying for Tax Exempt Status**



Source: GAO analysis of Internal Revenue Service (IRS) documents. | GAO-21-89

Note: Nonprofit organizations recognized by IRS as tax-exempt and nonprofit colleges recognized as such by the Department of Education (Education) are prohibited from using their earnings to improperly benefit private individuals. See 20 U.S.C. § 1003(13), 26 U.S.C. § 501(c)(3), and 26 C.F.R. § 1.501(c)(3)-1(c)(2).

<sup>a</sup>A for-profit college that seeks to reincorporate as a nonprofit organization generally must file paperwork with the state in which it is incorporated. Requirements vary by state, and may include dissolving for-profit ownership shares and drafting new articles of incorporation.

<sup>b</sup>Education has additional processes for approving a for-profit college to become a nonprofit college for federal student aid purposes.

Alternatively, IRS guidelines also note that a nonprofit tax-exempt organization may purchase a for-profit entity, such as a college, and operate it for tax-exempt purposes. A for-profit college can be purchased by an existing nonprofit college, an existing nonprofit organization that is not a college, or a new nonprofit organization created to purchase the college. In each case, the previously for-profit college would obtain tax-exempt status after its sale to the nonprofit organization<sup>18</sup> (See figure 2).

<sup>18</sup>The for-profit college itself does not obtain tax-exempt status in this type of conversion, but rather sells its assets to a distinct entity that is tax exempt. For ease of reference, we refer to the for-profit college as obtaining tax-exempt status in this report.

**Figure 2: Examples of a Nonprofit Organization with Tax-Exempt Status Purchasing a For-Profit College**

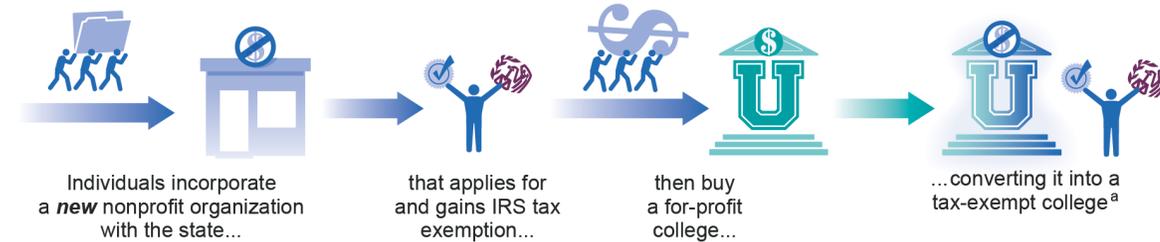
**Nonprofit college purchases a for-profit college**



**Existing nonprofit organization purchases a for-profit college**



**New nonprofit organization purchases a for-profit college**



Source: GAO analysis of Internal Revenue Service (IRS) documents. | GAO-21-89

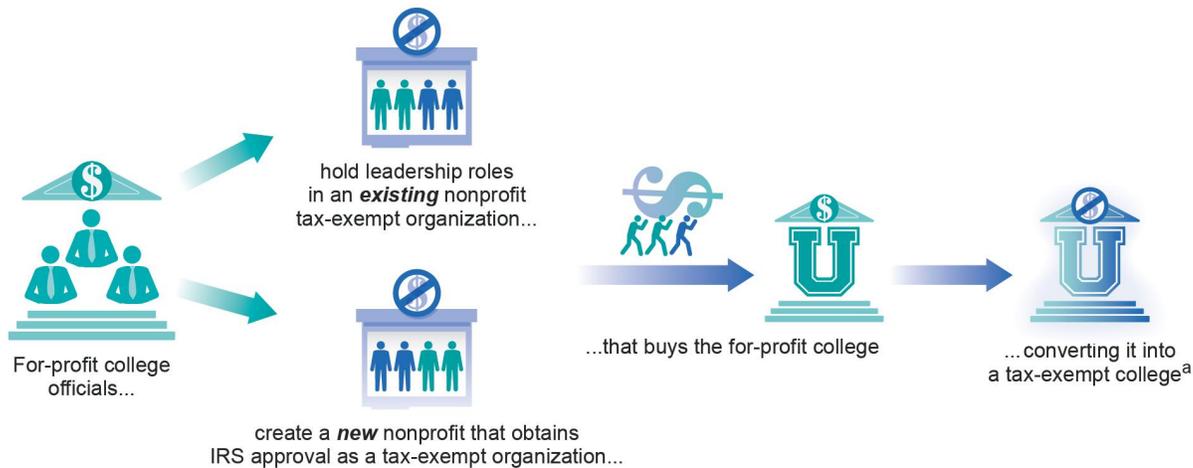
Note: Nonprofit organizations recognized by IRS as tax-exempt and nonprofit colleges recognized as such by the Department of Education (Education) are prohibited from using their earnings to improperly benefit private individuals. See 20 U.S.C. § 1003(13), 26 U.S.C. § 501(c)(3), and 26 C.F.R. § 1.501(c)(3)-1(c)(2).

<sup>a</sup>Education has additional processes for approving a for-profit college to become a nonprofit college for federal student aid purposes.

In some cases, a for-profit college may have a pre-existing relationship with the nonprofit organization that purchases it. For instance, for-profit college owners or executives may create a new nonprofit organization to purchase the college, or they may hold leadership roles in an existing nonprofit organization that purchases the college. IRS considers such individuals to be insiders to the nonprofit organization. The Internal Revenue Code does not prohibit tax-exempt organizations from having a relationship with a for-profit entity or from engaging in financial transactions with that entity. However, such relationships may enable insiders associated with both the nonprofit organization and for-profit

entity to influence the nonprofit organization’s financial decisions. Figure 3 illustrates two ways an insider may initiate a for-profit college conversion.

**Figure 3: Examples of How Insiders Can Initiate a For-Profit College Conversion**



Source: GAO analysis of Internal Revenue Service (IRS) documents. | GAO-21-89

Notes: IRS defines insiders as private shareholders or individuals with a personal and private interest in a tax-exempt organization’s activities who, through a special relationship with the organization, are able to influence its financial decisions. Insiders associated with a for-profit college conversion would include for-profit college owners, their family members, board members, or executives who held leadership roles in a nonprofit organization that purchases the college.

Nonprofit organizations recognized by IRS as tax-exempt and nonprofit colleges recognized as such by the Department of Education (Education) are prohibited from using their earnings to improperly benefit private individuals. See 20 U.S.C. § 1003(13), 26 U.S.C. § 501(c)(3), and 26 C.F.R. § 1.501(c)(3)-1(c)(2).

<sup>a</sup>Education has additional processes for approving a for-profit college to become a nonprofit college for federal student aid purposes.

## IRS Processes for Recognizing and Monitoring Tax-Exempt Organizations

The process by which a for-profit college obtains IRS tax-exempt status depends on its method of conversion. According to IRS procedures, if a for-profit college reincorporates as a nonprofit organization, it would generally be required to apply to IRS to obtain tax-exempt status.<sup>19</sup> If a

<sup>19</sup>Colleges seek exemption from federal taxation as educational organizations under section 501(c)(3) of the Internal Revenue Code. See 26 U.S.C. § 508. These organizations are generally required to submit an application for tax-exempt status—either the Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, or Form 1023-EZ, Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, as appropriate.

new nonprofit organization is created to purchase a for-profit college, the new nonprofit organization likewise applies to IRS for tax-exempt status and describes its intent to purchase and operate a college in its application. By contrast, if an existing tax-exempt organization purchases a for-profit college, it does not submit an application for tax-exempt status. Instead, it would describe its new activities, such as operating a college, on its next annual IRS filing.<sup>20</sup>

### IRS Application Review

According to IRS instructions, an organization applying for tax-exempt status, such as a for-profit college or its new nonprofit purchaser, is to provide information to IRS that includes organizing documents (such as articles of incorporation), a description of its activities, information on officer and executive compensation, and disclosure of financial transactions between the nonprofit organization and any of its officers, directors, or trustees. IRS uses this information to assess whether the applicant is organized and operated exclusively for a tax-exempt purpose (e.g., educational, scientific, charitable) and not for the benefit of private interests, such as those of the organization's founders. To qualify for tax-exempt status, no part of the applicant's net earnings may improperly benefit private individuals. Improper benefit is impermissible and is grounds for denial or revocation of tax-exempt status under the Internal Revenue Code (see text box).

#### **Improper Benefit**

Inurement, which GAO refers to in this report as improper benefit, occurs when the earnings of a tax-exempt organization are used to benefit persons with a personal and private interest in the activities of an organization. Such persons are typically insiders in a position to influence the organization's financial decisions. Improper benefit is impermissible for tax-exempt organizations, including colleges, under the Internal Revenue Code and for nonprofit colleges, under the Higher Education Act of 1965, as amended.

Source: 20 U.S.C. § 1003(13), 26 U.S.C. § 501(c)(3), and 26 C.F.R. § 1.501(c)(3)-1(c)(2). | GAO-21-89

IRS does not conduct an audit of an organization when it applies for tax-exempt status. Rather, the onus is on the applicant to affirm the accuracy of all financial and other information it submits for IRS's review. IRS generally relies on information provided by the applicant to determine if the requirements of tax-exempt status are met. However, IRS staff

<sup>20</sup>IRS Form 990, *Return of Organization Exempt From Income Tax*. IRS refers to this form as an annual information return. We refer to this form throughout this report as an annual IRS filing.

members may ask questions or request documentation to help them assess whether the organization meets the requirements of tax-exempt status.

### IRS Post-Approval Monitoring

Once approved, IRS is to monitor an organization's compliance with tax-exempt requirements according to agency procedures. The Internal Revenue Code generally requires tax-exempt organizations—including colleges—to submit annual filings that provide IRS with information on their activities and finances. According to IRS audit procedures, the agency selects tax-exempt organizations for audit primarily using indicators of potential noncompliance contained in these annual filings.<sup>21</sup> Further, per procedures, some audits are initiated as a part of special projects, known as compliance strategies, to focus on specific areas of tax noncompliance, such as improper benefit to insiders. IRS uses compliance strategies to identify specific compliance problems and improve IRS's overall compliance program, including better selection of the highest-risk cases for audit. If IRS finds tax noncompliance through an audit, it can impose penalties on an organization.

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## Education's Process for Reviewing For-Profit College Applications for Nonprofit Status and Monitoring Nonprofit Colleges

After obtaining IRS approval to operate as a tax-exempt organization, a for-profit college must separately obtain approval from Education to participate in federal student aid programs as a nonprofit college.<sup>22</sup> The

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<sup>21</sup>Technically, IRS selects an annual filing submitted by tax-exempt organizations for examination. In this report, we refer to this IRS process as an audit. We recently reviewed IRS's use of annual filing data in its audit selection methodology and found that IRS has not fully implemented or documented internal controls in its established processes for analyzing data for audit selection. We made 13 recommendations, including that IRS document measurable objectives for using data in audit selection and regularly review staff guidance on audit selection. GAO, *Tax Exempt Organizations: IRS Increasingly Uses Data in Examination Selection, but Could Further Improve Selection Processes*, [GAO-20-454](#) (Washington, D.C.: July 2020).

<sup>22</sup>Until Education approves a tax-exempt college's application for nonprofit college status, Education treats the college as a for-profit college for federal student aid purposes. Colleges are also required to report all changes in ownership for Education's approval. Education can approve a for-profit college's change in ownership to a tax-exempt owner, while denying the college's request to be treated as a nonprofit college.

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Higher Education Act has separate eligibility requirements for nonprofit and for-profit colleges to participate in federal student aid programs. To be recognized by Education as a nonprofit college, the college must be:

1. authorized to operate as a nonprofit by each state in which it is physically located;
2. recognized by IRS as a tax-exempt organization; and
3. owned and operated by a nonprofit organization whose earnings do not improperly benefit insiders.<sup>23</sup>

### Education's Application Review

A for-profit college or group of colleges with the same owner that undergoes a conversion transaction may submit an application to Education for nonprofit college status.<sup>24</sup> Education procedures require the college or college group to submit documentation, including (1) a current accreditation approval letter; (2) current approval to offer educational programs legally in the state in which it is located; (3) IRS approval of tax-exempt status; (4) two years of audited financial statements for the college or college group and the new tax-exempt owner; and (5) a copy of the college or college group's balance sheet as of the day it changed owners.<sup>25</sup> While a college or college group may submit this application before it has undergone a conversion transaction, Education will not formally approve or deny the application until after the conversion transaction has occurred. If Education approves the nonprofit application,

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<sup>23</sup>See 20 U.S.C. §§ 1003(13) and 1094(a). The Higher Education Act also requires colleges to be accredited by an entity (i.e., an accreditor) recognized by Education as a reliable authority on assessing academic quality. See 20 U.S.C. § 1001(a)(5). College accreditors must have adequate policies for approving substantive changes—such as a conversion from for-profit to nonprofit status—undertaken by member colleges. See 34 C.F.R. § 602.22(a).

<sup>24</sup>When multiple colleges in a for-profit college group are part of a conversion transaction and seek nonprofit college status from Education, the agency may consider the colleges' applications collectively as a group.

<sup>25</sup>Education uses college balance sheet data to calculate the college's acid test ratio and tangible net worth as of the day of its change in ownership. A passing acid test ratio indicates that a college has sufficient liquid assets (such as cash and incoming tuition payments) to cover debt that would be due within the following year. A positive tangible net worth indicates that a college has sufficient tangible assets (such as cash, investments, and property) to cover its total debts. Education may impose letter of credit requirements on colleges that do not meet one or both of these financial responsibility standards.

it considers the college nonprofit for federal student aid purposes. After a 1-year waiting period following approval of its nonprofit college status, the college is no longer required to demonstrate that at least 10 percent of its revenues come from sources other than federal student aid programs, a regulatory requirement specific to for-profit colleges.<sup>26</sup>

### Education's Post-Approval Monitoring

Once approved for nonprofit college status, Education's procedures require the college to participate in federal student aid programs under provisional approval for at least 1 to 3 years.<sup>27</sup> According to Education procedures, colleges that are provisionally approved are subject to additional requirements in order to participate in federal student aid programs—for instance, they may be temporarily prohibited from adding new programs or opening new locations—and are monitored to ensure they comply with the specified provisional conditions. Colleges that fail to meet provisional conditions may have their approval to participate in federal student aid programs revoked, and have a less substantive appeals process than fully certified colleges.

Education also has ongoing monitoring activities that are applicable to all colleges. Education procedures require the agency to monitor colleges by periodically recertifying their eligibility to participate in federal student aid programs and conducting more in-depth program reviews of selected colleges to ensure that they are complying with key federal student aid requirements. In addition, procedures require Education to annually review the audited financial statements of all colleges as part of its process to assess their financial health. This process includes calculating three financial ratios to develop an overall measure of a college's financial

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<sup>26</sup>This requirement is known as the "90/10 rule." Other revenue sources can include cash payments from students, private student loans, state education grants, and federal education assistance payments to veterans.

<sup>27</sup>Federal regulations require any college with an approved change in ownership to participate in a provisional status for 1 to 3 years, not just for-profit colleges seeking to change to a nonprofit owner.

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condition, which is known as a financial responsibility composite score.<sup>28</sup> Lastly, agency regulations call for Education to impose sanctions and corrective actions on colleges that violate program rules.

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## Some For-Profit College Conversions Involved Insiders, Which May Pose Risk of Improper Benefit

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### Since 2011, Almost All For-Profit College Conversions Have Resulted from a Sale to a Tax-Exempt Organization, and about One-Third Have Involved Insiders

We identified 59 for-profit colleges that underwent conversion transactions from January 2011 through August 2020, almost all (57) of which involved the for-profit college's sale to a nonprofit organization recognized by IRS as tax exempt.<sup>29</sup> Nearly three-fourths of the colleges in our review (43 of 59) were sold—and one additional college was donated—to an existing tax-exempt organization that was not a college. Nine of the 59 colleges in our review were sold to a new tax-exempt organization that was not itself a college and had been created specifically to purchase the college. Five of the 59 were sold to an existing tax-exempt nonprofit college. In one final case, the for-profit

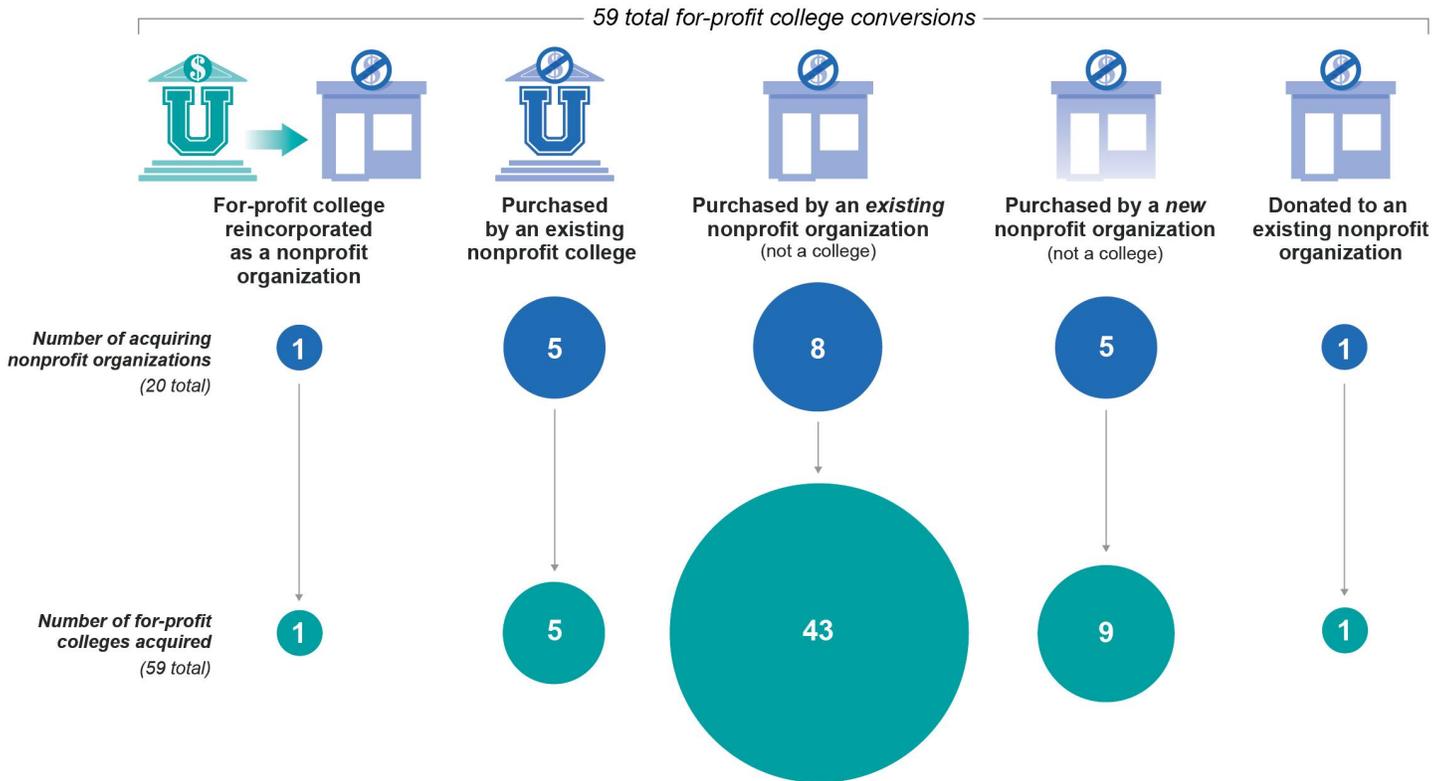
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<sup>28</sup>In a prior report, we reviewed Education's composite score and found that the agency did not incorporate financial metrics that would provide a broader indication of colleges' financial health, including measures of liquidity, historical trends, or projections of future performance. We made several recommendations including that Education update its composite score and publicly list each college's composite score. See GAO, *Higher Education: Education Should Address Oversight and Communication Gaps in Its Monitoring of the Financial Condition of Schools*, [GAO-17-555](#) (Washington, D.C.: Aug 21, 2017) Education has made some updates to its composite score, but has not incorporated metrics to provide a broader indication of colleges' financial health. Education implemented our recommendation to post composite scores for all colleges publicly.

<sup>29</sup>The data Education provided in April 2019 indicated that the first for-profit college applications for nonprofit college status in their records were from November 2010, and that the conversion transactions for these colleges occurred in January 2011. However, in June 2020 Education officials identified a for-profit college conversion that occurred in 1995. Because we were completing our audit work, we did not include this 1995 conversion in the scope of our review. Education officials confirmed that no additional colleges completed their conversion transactions and applied to it for nonprofit college status as of August 2020. Therefore, the universe of for-profit college conversions in our review spans January 2011 through August 2020.

college reincorporated as a nonprofit organization and obtained tax-exempt status without being sold<sup>30</sup> (see figure 4).

**Figure 4: Conversion Methods for 59 For-Profit Colleges, January 2011 through August 2020**



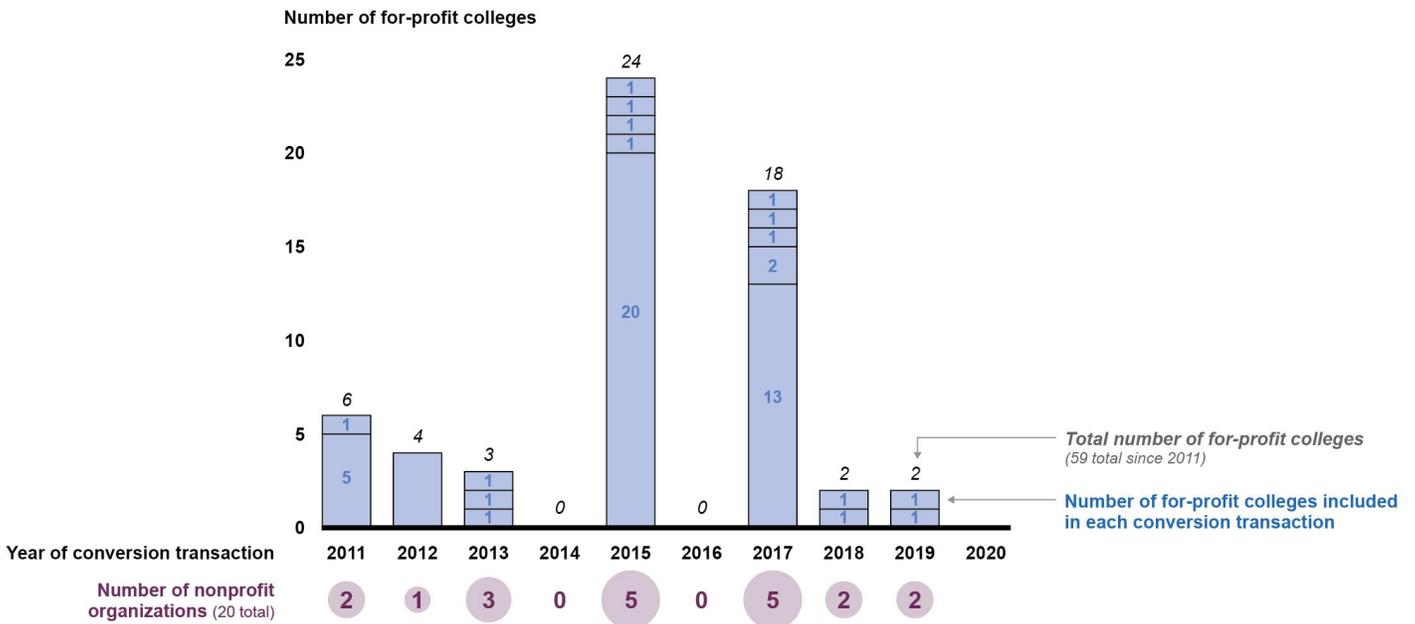
Source: GAO analysis of Internal Revenue Service (IRS) documents. | GAO-21-89

Notes: GAO used the term “nonprofit organization” to refer to an organization recognized by IRS as tax-exempt and “conversion” to refer to a college’s transition from for-profit ownership to ownership by a nonprofit organization recognized by IRS as tax-exempt. This review included all for-profit colleges that had (1) undergone a conversion transaction between January 2011 and August 2020 and (2) submitted an application to Education to be recognized as a nonprofit college or to merge with an existing nonprofit college as of August 2020, regardless of whether Education made a decision to approve or deny the application. The 59 colleges in GAO’s review were acquired by 20 separate tax-exempt organizations. In most cases (15 of 20), just one college was acquired. However, in five cases, the tax-exempt organization purchased more than one college—up to 20 colleges in one case.

<sup>30</sup>Throughout this report, we use the term for-profit college conversion to refer to a college’s transition from for-profit ownership to ownership by a nonprofit organization recognized by IRS as tax-exempt. The college must separately apply to Education for nonprofit college status. See 20 U.S.C. §§ 1003(13) and 1094(a).

The 59 colleges in our review were acquired by 20 separate tax-exempt organizations.<sup>31</sup> In a few cases, the tax-exempt organization acquired more than one college—up to 20 colleges in one case (see figure 5). The colleges in our review received about \$2.3 billion in federal student aid funds in the 2018-2019 award year, the most recent award year for which this information was available at the time of our review.<sup>32</sup>

**Figure 5: For-Profit College Conversions, by Year of Conversion Transaction, January 2011 through August 2020**



Source: GAO analysis of Department of Education documents. | GAO-21-89

Notes: GAO used the term “nonprofit organization” to refer to an organization recognized by IRS as tax-exempt and “conversion” to refer to a college’s transition from for-profit ownership to ownership by a nonprofit organization recognized by IRS as tax-exempt. This review included all for-profit colleges that had (1) undergone a conversion transaction between January 2011 and August 2020 and (2) submitted an application to Education to be recognized as a nonprofit college or to merge with an existing nonprofit college as of August 2020, regardless of whether Education made a decision to approve or deny the application. The 59 colleges in GAO’s review were acquired by 20 separate tax-exempt organizations. In most cases (15 of 20), just one college was acquired. However, in five cases, the tax-exempt organization purchased more than one college—up to 20 colleges in one case.

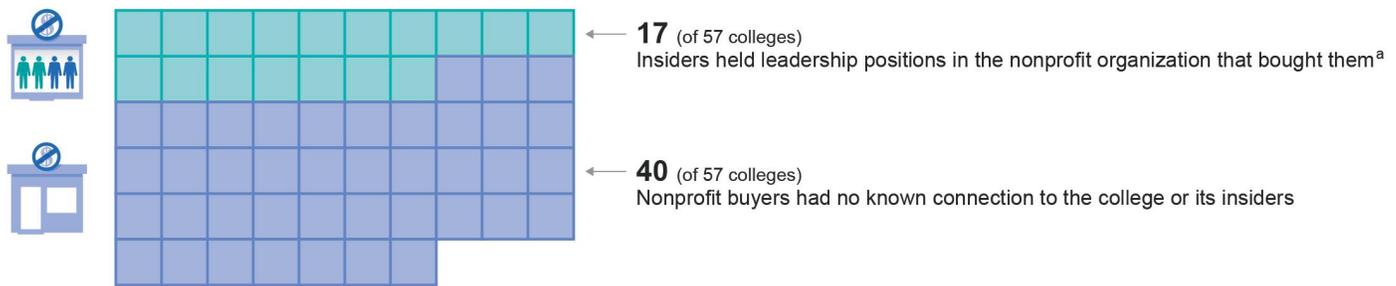
<sup>31</sup>In one case, the for-profit college itself reincorporated as a nonprofit organization (rather than being purchased by a separate nonprofit organization).

<sup>32</sup>Federal student aid award years run from July 1 to June 30. Of the 59 colleges in our review, 15 closed or merged with another related college in our review prior the 2018 - 2019 award year and received no federal student aid funds as a result. The other 44 colleges in our review accounted for all \$2.3 billion in federal student aid funding received.

While for-profit colleges that have converted to tax-exempt status have generally been sold to a nonprofit organization, one reincorporated as a nonprofit organization, and another was donated to a nonprofit organization.

We reviewed public IRS filings and found that in nearly one-third of cases with available information (17 of 57), for-profit college officials were insiders to the college's nonprofit purchaser, holding nonprofit leadership roles before or upon conclusion of the conversion transaction.<sup>33</sup> By contrast, the other two-thirds of colleges in our review (40 of 57) were sold to unrelated nonprofit organizations<sup>34</sup> (see figure 6). Collectively, colleges whose conversions involved insiders received nearly \$1.8 billion in federal student aid funds in the 2018-2019 award year.<sup>35</sup>

**Figure 6: For-Profit College Conversions with and without Insider Involvement, January 2011 through August 2020**



Source: GAO analysis of Internal Revenue Service (IRS) documents. | GAO-21-89

Note: GAO used the term “nonprofit organization” to refer to an organization recognized by IRS as tax-exempt and “conversion” to refer to a college’s transition from for-profit ownership to ownership by a nonprofit organization recognized by IRS as tax-exempt. This review included all for-profit colleges

<sup>33</sup>If for-profit college officials did not hold nonprofit leadership positions before the conversion transaction, we assessed only whether insiders with a more than 35-percent stake in the college assumed nonprofit leadership positions upon its completion. (If for-profit college executives stayed in their positions after the sale, but owners did not retain a role in the tax-exempt college, we did not consider the conversion to involve for-profit college officials as insiders.) Leadership positions in the tax-exempt college included chief executive officer, college president, board chair, or board member.

<sup>34</sup>We excluded two of 59 colleges from this analysis. In one case, we did not have sufficient information to assess the relationship between one for-profit college and the nonprofit organization that purchased it. In the other case, the college had previously been recognized by Education as nonprofit, but lost its IRS tax-exempt status after IRS found it had violated racial nondiscrimination rules applicable to tax-exempt schools and colleges. As a result, it no longer met Education’s definition of a nonprofit college. The college was later donated to a tax-exempt school associated with the college and regained its tax-exempt status from IRS.

<sup>35</sup>Of the 17 colleges whose conversions involved insiders in our review, one closed prior to the 2018-2019 award year and three merged with another related college in our review. These colleges did not separately receive any federal student aid funds in the 2018-2019 award year as a result.

that had (1) undergone a conversion transaction between January 2011 and August 2020 and (2) submitted an application to Education to be recognized as a nonprofit college or to merge with an existing nonprofit college as of August 2020, regardless of whether Education made a decision to approve or deny the application. The 57 colleges in this analysis were acquired by 18 separate tax-exempt organizations. In most cases (13 of 18), just one college was acquired. However, in five cases, the tax-exempt organization purchased more than one college—up to 20 colleges in one case. Insiders are defined as persons with a personal and private interest in a tax-exempt organization's activities who, by virtue of a special relationship with the organization, are able to influence its financial decisions. GAO considered for-profit college officials to be insiders to the college's nonprofit purchaser if (1) for-profit college owners, their family members, board members, or executives held leadership roles in the nonprofit organization that purchased the college or (2) for-profit college owners with a more than 35-percent stake in the college assumed nonprofit leadership roles after the purchase was complete. Tax-exempt organizations are not prohibited from entering into financial transactions with insiders. However, it is prohibited for such transactions to improperly benefit those individuals' private financial interests over the financial interests of the nonprofit organization.

<sup>a</sup>In one case, the for-profit college reincorporated as a nonprofit organization rather than being sold to an outside nonprofit organization. The for-profit college's owners continued to lead the college after its reincorporation.

Eight of the 17 for-profit colleges whose conversions involved insiders were purchased by nonprofit organizations created specifically for the conversion transaction. These nonprofit organizations did not carry out any activities prior to purchasing the college. Among the other nine of 17 for-profit colleges whose conversions involved insiders, eight were purchased by an existing nonprofit organization and one reincorporated as a nonprofit organization rather than being sold to an outside nonprofit organization.<sup>36</sup> By contrast, among the 40 for-profit college conversions that did not involve insiders, one college was purchased by a new nonprofit organization created specifically to purchase the college. The other 39 colleges were purchased by existing nonprofit organizations, including three that already operated nonprofit colleges.<sup>37</sup>

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## While Involvement of Insiders in For-Profit College Conversions Poses Risk of Improper Benefit, Officials from Five Case Study Colleges also Reported Benefits

When for-profit college officials are insiders to a conversion—holding leadership positions in the college's nonprofit purchaser before or

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<sup>36</sup>In three of the eight cases where the college was purchased by an existing nonprofit organization, insiders already held leadership roles in the nonprofit organization prior to the conversion transaction. In the other five of eight cases, former for-profit college owners assumed leadership roles in the resulting tax-exempt college as soon as the conversion transaction was complete. For the college that reincorporated as a nonprofit organization, insiders maintained leadership positions in the college after its conversion.

<sup>37</sup>Other nonprofit purchasers included community-based organizations, private foundations, and a nonprofit student loan guarantor.

immediately after the conversion transaction—there may be benefits to the college but also risks of improper benefit. Insiders may initiate the conversion for beneficial reasons, such as expanding student opportunities or aligning the college’s status with its mission, according to officials from our five case study colleges. However, holding leadership roles in both the college’s for-profit seller and nonprofit purchaser could also enable the insiders to improperly benefit from the conversion transaction, according to IRS officials.<sup>38</sup> For instance, if the board of a nonprofit organization seeks to purchase a college from insiders and does not exercise due diligence to assure that sale terms proposed by the insider are fair, improper benefit could result.<sup>39</sup> In such a case, insiders with an ownership stake in the college would improperly benefit if they influenced the nonprofit organization to pay more to purchase the college than it was worth (see figure 7).

**Figure 7: Hypothetical Example of How Insiders Could Improperly Benefit from a For-Profit College’s Sale to a Nonprofit Organization**



Source: GAO analysis of Internal Revenue Service (IRS) documents. | GAO-21-89

Note: The term “nonprofit organization” refers to an organization recognized by IRS as tax -exempt. Inurement, referred to in this report as improper benefit, is impermissible under the Internal Revenue Code and the Higher Education Act of 1965, as amended, for tax-exempt organizations and nonprofit colleges, respectively. It occurs when a tax -exempt organization’s or nonprofit college’s earnings benefit the private interests of insiders, who by virtue of a special relationship with the organization have the ability to influence its financial decisions, rather than the interests of the organization. Tax -exempt organizations are not prohibited from entering into financial transactions with insiders.

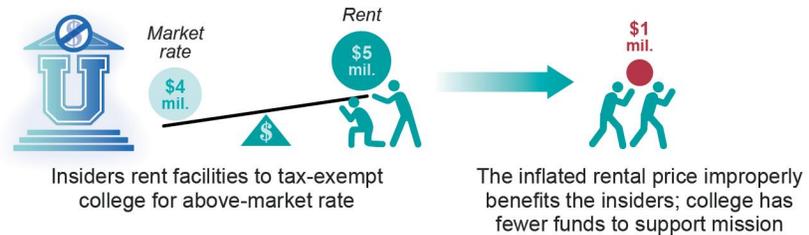
<sup>38</sup>Tax-exempt organizations are not prohibited from entering into financial transactions with insiders. For instance, nonprofit board members or executives may sell property to nonprofit organizations or operate businesses that provide services to them. However, it is prohibited for such transactions to benefit those individuals’ private financial interests over the financial interests of the nonprofit organization. See 26 C.F.R. § 1.501(c)(3)-1(c)(2).

<sup>39</sup>Nonbinding IRS governing board guidelines note that the culture of a nonprofit organization’s board may increase its vulnerability to improper benefit, particularly if there is a lack of open communication or active oversight on the board. These guidelines also state that boards should not be dominated by individuals who are not, by their very nature, independent due to business or family relationships.

How ever, it is prohibited for such transactions to improperly benefit the financial interests of insiders over those of the nonprofit organization.

When former for-profit college officials retain leadership positions in the college after selling it, there may be additional benefits and risks to the college. The college may benefit from the continued stewardship of individuals with a thorough understanding of the college and its operations, as described by officials from some of our five case study colleges. However, if insiders, such as former owners, continue to influence the college’s decisions to further their own private financial interests rather than support the college’s mission, improper benefit would result, under the Internal Revenue Code.<sup>40</sup> An example of such improper benefit would be a former owner who continues to lead a tax-exempt college and influence it to enter into unfavorable contracts with companies the insider owns, such as by renting facilities to the college for more than their market rate (see figure 8).

**Figure 8: Hypothetical Example of How Insiders Could Improperly Benefit from Transactions with a Previously For-Profit College after its Sale to a Nonprofit Organization**



Source: GAO analysis of Internal Revenue Service (IRS) documents. | GAO-21-89

Note: The term “nonprofit organization” refers to an organization recognized by IRS as tax -exempt. Inurement, referred to in this report as improper benefit, is impermissible under the Internal Revenue Code and the Higher Education Act of 1965, as amended, for tax -exempt organizations and nonprofit colleges, respectively. It occurs when a tax -exempt organization’s or nonprofit college’s earnings benefit the private interests of insiders, who by virtue of a special relationship with the organization have the ability to influence its financial decisions, rather than the interests of the organization. Tax -exempt organizations are not prohibited from entering into financial transactions with insiders. However, it is prohibited for such transactions to improperly benefit the interests of insiders over the financial interests of the nonprofit organization.

**Roles of insiders in five case study conversions.** Among the five case study colleges that we selected for more in-depth review whose conversions involved for-profit college officials as insiders, the insiders led the college’s nonprofit purchaser before the conversion transaction in four cases, and assumed leadership positions in the tax-exempt college

<sup>40</sup>See 26 U.S.C. § 501(c)(3) and 26 C.F.R. § 1.501(c)(3)-1(c)(2).

upon conclusion of the transaction in all five cases.<sup>41</sup> These cases are not representative of all for-profit college conversions with insider involvement, but rather serve as illustrative examples. Among the four cases in which insiders led the college's nonprofit purchaser prior to the conversion, the insiders:

- founded a nonprofit organization expressly to purchase the college in one case,
- founded an educational nonprofit organization that later purchased the college in two cases, and
- chaired the board of an existing educational nonprofit organization that later purchased the college in the last case.

After selling the college, insiders continued in their role as president or chief executive officer of all five newly tax-exempt colleges. These insiders all had ownership stakes in the for-profit college before its sale.<sup>42</sup> In three of the five cases, college officials confirmed that insiders also assumed roles on the board of the newly tax-exempt college.<sup>43</sup>

After each sale, insiders with ownership stakes in the for-profit colleges also maintained ongoing financial ties with the colleges in all five cases. Each conversion transaction was financed by the college's for-profit seller, rather than a bank, and the colleges owed loan payments directly to the seller as a result. Insiders with an ownership stake in each for-profit seller continued to lead the college as its president or chief executive

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<sup>41</sup>As described earlier in this report, we judgmentally selected these five case study colleges based on the involvement of insiders in the colleges' conversion transactions and other criteria. In particular, we also considered risk factors in two additional areas: Education's evaluation of the colleges' financial condition for the year before and year of their conversion transaction and the amount of federal student aid funding they received in the year before the transaction. We selected five colleges for review that possessed one or both of the risk factors we identified in these areas: (1) declining financial condition following the college's conversion, and (2) relatively high level of federal student aid funding in the year before conversion, compared to other colleges in our universe.

<sup>42</sup>In two of the five cases, the nonprofit college president or chief executive officer had a greater than 35 percent ownership stake in the college. In the other three cases, that individual had a less than 35 percent stake in the college.

<sup>43</sup>In two cases, officials reported that the tax-exempt college board did not include any shareholders in the for-profit college.

officer while the college made loan payments to the seller.<sup>44</sup> In one of these cases, loan payments to the college's president and former owner were set to equal the college's available cash balance.<sup>45</sup> In four cases, former owners extended additional loans to the colleges for operational or other expenditures at the time of the sale. Former owners also acted as landlord to the college in two of the five cases, leasing properties back to the tax-exempt college that were not included in the original sale. In one of these two cases, the former owner also later sold programs offered at the campuses of another for-profit college to the tax-exempt college.<sup>46</sup> Lastly, in three of five cases, former owners acted as vendors to the tax-exempt college while insiders served as the college's president. One college president owned companies that provided a wide variety of services to the college. In another case, the college president was also the chief executive of the college's former corporate owner, which provided extensive services to the college.

Officials from all five case study colleges whose conversions involved insiders described a variety of positive goals for their college's conversion and benefits it provided. In four of the five cases, officials said they converted in part to enhance the student experience, for instance by expanding partnerships with local nonprofit employers, enabling students to access certain state grants, and improving employers' perception of students' degrees. In one case, officials said nonprofit status helped the college realize its plans to develop a campus, which had previously met local resistance, to provide students with the option of a traditional residential college experience. In three of five cases, college officials also stated that securing nonprofit status helped align the college's status with its character or mission. In one of these cases, the college's acquisition by a nonprofit organization was part of a succession plan in anticipation of

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<sup>44</sup>In one case, college officials stated that the debt financed by the former for-profit owner was subordinated to all other debt and creditors.

<sup>45</sup>In this case, college officials stated that the former owner was only entitled to loan payments if the college had available cash in excess of reserves specified in the loan agreement. Officials further stated that the college had made no principal payments on the loan to date.

<sup>46</sup>The tax-exempt college also advanced funds to the corporate entity that owned these campuses (and was controlled by the former owner) before it purchased the campuses' programs.

the college owner's eventual retirement.<sup>47</sup> Officials from two of five colleges said conversion helped enhance college resources by allowing the college to accept charitable contributions.

Officials from all five case study colleges also described benefits from the ongoing leadership of former for-profit college officials familiar with the college. Officials from one college said the nonprofit organization's board believed that the for-profit college president's continued leadership was essential to the tax-exempt college's success. In another case, officials said that the temporary leadership of former owners helped ease the college's ultimate transition to new management.<sup>48</sup> In a third case, officials said that the college's accreditor required the new owner to have sufficient educational expertise to operate the college, and that the former owner provided that expertise.

Officials from all five case study colleges also reported safeguards that could mitigate the risk of improper benefit associated with their conversion transactions or subsequent transactions with insiders. For instance, in the four cases where for-profit college officials were insiders to the nonprofit organization that purchased the college, officials said the insiders either were not involved in negotiations (three colleges) or recused themselves from negotiations, when it was appropriate to do so (one college).<sup>49</sup> Officials from all five colleges also reported using professional opinions from independent experts, such as financial

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<sup>47</sup>In this case, college officials stated that the former owner had turned down previous offers to sell the college to large for-profit educational groups, due to concerns that the unique character of the school would be lost.

<sup>48</sup>In this case, one former owner served as president of the tax-exempt college for about 2 years, and then transitioned to a senior advisor role along with another former owner.

<sup>49</sup>In one of the three case in which college officials said insiders were not involved in negotiations, officials said the for-profit college owners stepped down from their nonprofit leadership roles before the negotiations began. In the second case, college officials said the nonprofit organization created a committee to negotiate the purchase that did not include insiders with an ownership stake in the college. In the third case, officials said the nonprofit board did not include any member with an ownership stake in the for-profit college.

valuation firms or appraisers, to inform their negotiations.<sup>50</sup> These officials further reported that the nonprofit purchasers had conflict of interest policies—policies that could prevent insiders from influencing transactions in which they had a personal interest.

Officials from four of five colleges also described taking steps over time to end or reduce certain financial ties with former owners.<sup>51</sup> In two of the five cases where former owners financed the college sale, college officials noted that they later refinanced the loans with unrelated parties.<sup>52</sup> Officials from two other colleges stated that former owners, while still creditors to the colleges, had reduced loan principal owed by the colleges and taken other steps to enhance the financial stability of the colleges.<sup>53</sup> Officials from one of the two colleges that leased properties from its former owner stated that those properties were later donated to the college. Officials from the other college stated that it had purchased some of the properties leased from its former owner at their appraised value and planned to eliminate remaining leases in the future. Finally, officials from one of the three colleges that contracted with former owners for goods or services said the contracts had lapsed were replaced by contracts with an unrelated party.

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<sup>50</sup>We reviewed opinions used in two of these five cases. In one, the nonprofit buyer commissioned an outside opinion evaluating whether the purchase price was fair to the buyer. In the other, the for-profit college commissioned an opinion of the college's value, and both the buyer and seller relied on that opinion when negotiating the transaction. The opinions cited by officials from the three other case study colleges were not included in the public IRS documentation or other materials we reviewed.

<sup>51</sup>Officials from the fifth college did not describe steps to end financial ties with former owners. However, they stated that the tax-exempt college's board was independent from its former for-profit owner and current service provider, as its bylaws precluded members from holding shares in the company, which was led by the college president.

<sup>52</sup>In one case, officials said the college used proceeds from a public bond issuance to repay debt from the college sale to its former owners. In the other case, the college owner later forgave part of the outstanding debt from the college sale, and the college later refinanced the rest of its outstanding loans with commercial lenders.

<sup>53</sup> In one case, college officials confirmed that the reduced loan value was considered a contribution by the former owner. In this case, the former owner also forgave certain interest owed by the college as a charitable contribution. In the other case, the former owner donated certain interest paid by the college back to the college.

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## Short-Term Declines in Financial Performance on Education Measures Were More Common for Colleges Whose Conversions Involved Insiders

Using Education financial measures, we found that colleges converting with insiders involved generally had stronger performance before the conversion, but weaker performance in the year after their sale, whereas the opposite was true for most colleges converting without insiders involved. All 16 of the for-profit colleges whose conversions involved insiders and had available information had a passing financial responsibility composite score—which Education calculates annually to assess a college’s financial health—in the year before its sale.<sup>54</sup> However, almost all of these colleges (15 of 16) had a failing composite score in the year of its sale<sup>55</sup> (See figure 9). Further, 15 of these 16 colleges failed one or both financial measures Education calculates immediately following a for-profit college’s change in ownership. Specifically, 15 of the 16 had a negative tangible net worth, or insufficient tangible assets (such as cash, investments, and property) to cover their total debts. Five of the 16 also had a failing acid test ratio, or insufficient liquid assets (such as cash and incoming tuition payments) to cover debt due within the following year.<sup>56</sup>

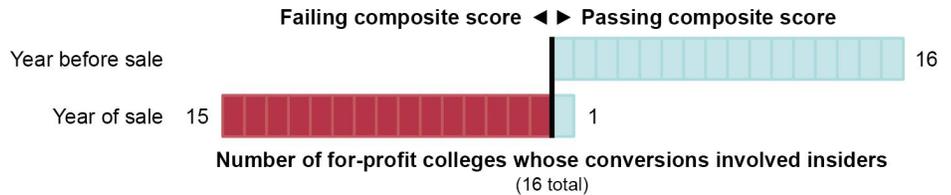
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<sup>54</sup>Education calculates the financial responsibility composite score using audited financial statement data for all for-profit and nonprofit colleges annually. It is composed of three financial ratios: (1) the primary reserve ratio, which measures whether the college has sufficient resources to cover its expenses; (2) the equity ratio, which measures how much the college owns versus how much it owes; and (3) the net income ratio, which measures whether the college operates within its means. Education uses slightly different formulas when calculating these ratios for nonprofit and for-profit schools. See 34 C.F.R. § 668.172 and apps. A-B.

<sup>55</sup>Education requires colleges with failing composite scores to provide letters of credit of at least 10 percent of their federal student aid funds from its most recent fiscal year as an assurance to Education against potential losses. Colleges obtain the letter of credit from a bank, which charges them a fee for this service—typically a percentage of the value of the letter of credit. The letter of credit protects Education against potential liabilities for student refunds, loan cancellation costs, and other costs associated with a college closure. In such cases, Education can cash the letter of credit to cover any outstanding debts owed by the college. In addition to providing a letter of credit, colleges with failing composite scores must also agree to heightened cash monitoring and other oversight requirements.

<sup>56</sup>The final college whose conversion involved insiders did not yet have a composite score available for the year of its conversion transaction at the time of our review, but its acid test and tangible net worth ratio were available. This college had a positive tangible net worth and passing acid test ratio. Education requires colleges with a negative tangible net worth or a failing acid test ratio (of less than one) to provide a letter of credit to be considered financially responsible.

**Figure 9: Financial Responsibility Composite Scores of For-Profit Colleges Whose Conversion Transaction Involved Insiders, Year before and Year of The Transaction**



Source: GAO analysis of Department of Education (Education) data. | GAO-21-89

Notes: GAO used the term “nonprofit organization” to refer to an organization recognized by IRS as tax-exempt and “conversion” to refer to a college’s transition from for-profit ownership to ownership by a nonprofit organization recognized by IRS as tax-exempt. This review included all for-profit colleges that had (1) undergone a conversion transaction between January 2011 and August 2020 and (2) submitted an application to Education to be recognized as a nonprofit college or to merge with an existing nonprofit college as of August 2020, regardless of whether Education made a decision to approve or deny the application.

Insiders are defined as persons with a personal and private interest in a tax-exempt organization’s activities who, by virtue of a special relationship with the organization, are able to influence its financial decisions. GAO considered for-profit college officials to be insiders in a conversion if (1) for-profit college owners, their family members, board members, or executives held leadership roles in the nonprofit organization that purchased the college or (2) for-profit college owners with a more than 35-percent stake in the college assumed nonprofit leadership roles after the purchase was complete. Tax-exempt organizations are not prohibited from entering into financial transactions with insiders. However, it is prohibited for such transactions to improperly benefit those individuals’ private financial interests over the financial interests of the nonprofit organization.

Education conducts annual financial responsibility reviews for all for-profit and nonprofit colleges that participate in federal student aid programs and calculates a financial responsibility composite score as a part of this review. Education conducts one financial review for each group of colleges with the same owner; as a result, those colleges in GAO’s review that shared the same for-profit owner prior to their conversion and the same nonprofit owner after their conversion generally would also share the same financial responsibility composite score. This score is composed of three financial ratios that measure whether the college has sufficient resources to cover its expenses (primary reserve ratio), how much the college owns versus how much it owes (equity ratio), and whether the college operates within its means (net income ratio). Education requires colleges with failing scores to provide a letter of credit and agree to heightened cash monitoring and other oversight requirements. Education uses slightly different formulas when calculating these ratios for nonprofit and for-profit schools. See 34 C.F.R. § 668.172 and apps A-B.

By contrast, the large majority of for-profit colleges that converted without insider involvement were in financial distress before their sale.

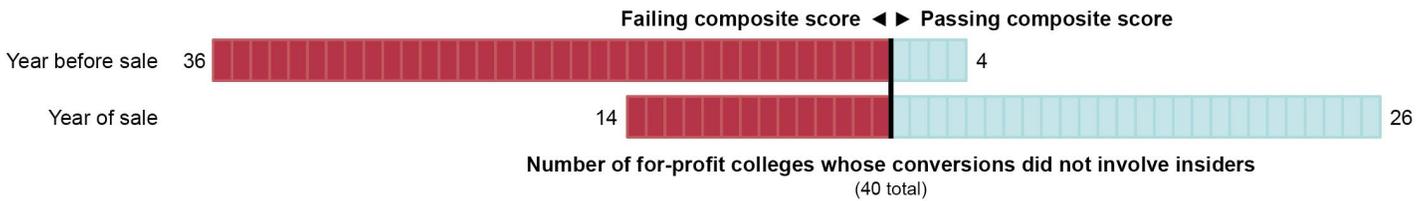
Specifically, 36 of 40 had failing financial responsibility composite scores and 33 were nearing bankruptcy.<sup>57</sup> After their sales, most of these colleges (26 of 40) had passing financial responsibility composite scores<sup>58</sup> (See figure 10). None of the colleges with available data had a negative

<sup>57</sup>The 33 colleges nearing bankruptcy were part of two separate conversion transactions involving groups of for-profit colleges sold to two different nonprofit purchasers.

<sup>58</sup>The other 14 colleges had failing composite scores before and after their sale. All but one of these colleges were purchased by the same nonprofit organization from a large for-profit college chain nearing bankruptcy.

tangible net worth after their conversion, and only one had a failing acid test ratio.<sup>59</sup>

**Figure 10: Financial Responsibility Composite Scores of For-Profit Colleges Whose Conversion Transaction Did Not Involve Insiders, Year before and Year of The Transaction**



Source: GAO analysis of Department of Education (Education) data. | GAO-21-89

Notes: GAO used the term “nonprofit organization” to refer to an organization recognized by IRS as tax-exempt and “conversion” to refer to a college’s transition from for-profit ownership to ownership by a nonprofit organization recognized by IRS as tax-exempt. This review included all for-profit colleges that had (1) undergone a conversion transaction between January 2011 and August 2020 and (2) submitted an application to Education to be recognized as a nonprofit college or to merge with an existing nonprofit college as of August 2020, regardless of whether Education made a decision to approve or deny the application.

Insiders are defined as persons with a personal and private interest in a tax-exempt organization’s activities who, by virtue of a special relationship with the organization, are able to influence its financial decisions. GAO considered for-profit college officials not to be insiders in a conversion if: (1) for-profit college owners, their family members, board members, or executives did not hold leadership roles in the nonprofit organization that purchased the college or (2) for-profit college owners with a more than 35 percent stake in the college did not assume nonprofit leadership roles after the purchase was complete. Tax-exempt organizations are not prohibited from entering into financial transactions with insiders. However, it is prohibited for such transactions to improperly benefit those individuals’ private financial interests over the financial interests of the nonprofit organization.

Education conducts annual financial responsibility reviews for all for-profit and nonprofit colleges that participate in federal student aid programs and calculates a financial responsibility composite score as a part of this review. Education conducts one financial review for each group of colleges with the same owner; as a result, those colleges in GAO’s review that shared the same for-profit owner prior to their conversion and the same nonprofit owner after their conversion generally also share the same financial responsibility composite scores. This score is composed of three financial ratios that measure whether the college has sufficient resources to cover its expenses (primary reserve ratio), how much the college owns versus how much it owes (equity ratio), and whether the college operates within its means (net income ratio). Education requires colleges with failing scores to provide a letter of credit and agree to heightened cash monitoring and other oversight requirements. Education uses slightly different formulas when calculating these ratios for nonprofit and for-profit schools. See 34 C.F.R. § 668.172 and apps. A-B.

According to Education officials, a college’s financial condition may decline or improve following its sale depending on factors such as the relative size and financial resources of the college and its purchaser. One

<sup>59</sup>Data were not available for three of the 40 colleges. In one case, Education officials said that the agency did not calculate the tangible net worth at the time of the conversion nor provide a tangible net worth calculation for the college at the time of our review. In two additional cases, Education officials said a tangible net worth and acid test ratio calculations were not required to be calculated because the colleges merged with another college that already participated in federal student aid programs.

Education official stated that if a college's nonprofit purchaser assumes a high level of debt to purchase the college or has limited access to working capital, it could harm the college's financial health. Conversely, another Education official stated that if a college's purchaser is more financially stable than the college it is purchasing, it may strengthen the college's financial health.

We compared the conversion transactions of our five case study colleges to five randomly selected colleges whose conversions did not involve insiders and identified two factors that may have contributed to the case study colleges' generally poorer composite score performance in the year of their conversions.<sup>60</sup> First, four of the five case study colleges purchased mostly intangible assets—such as goodwill, brand names, accreditation, and established student relationships—from the for-profit college sellers, and two bought intangible assets almost exclusively.<sup>61</sup> By comparison, all five randomly selected colleges purchased mostly tangible assets—such as cash, investments, and property—and two bought no intangible assets at all. Education excludes intangible assets from its composite score, and taking on debt to purchase intangible assets reduces a college's performance along this measure.<sup>62</sup> Officials from three of our five case study colleges said this exclusion led to an unfair characterization of their colleges' financial conditions. Purchasers may value a college more highly if it has a strong brand name, numerous established student relationships, or other intangible assets expected to yield future value.<sup>63</sup> However, intangible assets are also inherently difficult to value. One case study college whose sale price consisted almost entirely of intangible assets later claimed a substantial loss on those assets, citing a less

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<sup>60</sup>Other factors may also have contributed to the differences in composite scores between the five case study colleges and the five randomly selected colleges.

<sup>61</sup>In general, purchasers pay the current perceived value of owning intangible assets, taking into account expectations about future performance. In these two cases, 90 percent or more of assets purchased were intangible.

<sup>62</sup>The financial firm Education hired to help develop its composite score recommended excluding intangible assets from the measure because they do not generate cash flow streams and are likely to lose their value if a college experiences financial distress. Instead, the firm recommended that the composite score measure focus on whether a college has adequate capital to support its operations and deliver appropriate services.

<sup>63</sup>A college that primarily offers instruction online or leases (rather than owns) campus space may also have more intangible assets than tangible assets.

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optimistic regulatory outlook than previously anticipated, among other factors.<sup>64</sup>

Second, all five case study colleges financed their conversion transaction entirely with debt, meaning that rather than paying for the college up front, the nonprofit purchasers used borrowed funds—in these cases, from the colleges' former owners. By contrast, in four of the five randomly selected cases, the colleges' nonprofit purchasers paid for the college at the time of sale and did not assume any debt to do so. Debt can reduce a college's ability to weather financial difficulties, and it reduces a college's composite score performance. However, colleges can also reduce their debt over time, thereby improving their composite scores. For example, two of the four case study colleges with conversions involving insiders and failing composite scores in the year of their conversion transaction improved to passing scores in the most recent year available. These colleges both repaid some debt associated with their change in ownership. In addition, former owners forgave a substantial proportion of both colleges' outstanding debt in the years following the sale. This debt reduction had a positive effect on both colleges' composite scores.

While assessing the current financial condition of all converted colleges was not within the scope of our review, it is important to note that a college's financial condition may change over time. A college whose financial condition improves after its sale may ultimately experience declining financial condition, for instance, if it has sustained difficulty attracting and retaining students or its new owners lack expertise needed to successfully operate a college.<sup>65</sup> Conversely, a college whose financial

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<sup>64</sup>College officials stated that after engaging experts and performing its own study, the college reduced the value of intangible assets on its balance sheet, as required by generally accepted accounting principles, and reported a corresponding loss on its income statement, recognizing that the value was impaired.

<sup>65</sup>In two notable cases in our review, two nonprofit organizations purchased groups of colleges with failing composite scores from two large for-profit college chains on the edge of bankruptcy without insiders involved, but later closed a number of those colleges. In one case, the nonprofit purchaser agreed to take other steps to resolve student and Education concerns, including reducing tuition and providing new scholarships and grants. These colleges had passing composite scores in the year of their conversion. Further, the nonprofit purchaser committed significant additional funding from its other operations to support the colleges. However, the colleges faced sustained financial and other challenges, and 17 of 20 ultimately closed. In the other case, the colleges had failing composite scores in both the year before and year of their conversion, and after less than 2 years the colleges' nonprofit purchaser entered into federal receivership, stating that it was unable to meet its financial obligations. Nine of the 13 colleges closed and four were sold to another nonprofit organization.

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condition declines after its sale may ultimately experience improved financial circumstances if it improves its ability to attract and retain students or it obtains greater resources through increased charitable contributions or reduced tax liabilities.

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## IRS Has Not Consistently Identified and Responded to Risks That Insiders May Improperly Benefit from Previously For-Profit Colleges

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### IRS Staff Did Not Always Seek Information to Assess the Risk of Improper Benefit to Insiders When Reviewing Applications for Tax-Exempt Status

#### Fair Market Value

According to Department of the Treasury (Treasury) regulations, fair market value is the price at which an asset (such as a college) would change hands between a willing buyer and willing seller, when both have reasonable knowledge of the relevant facts and neither is obligated to buy or sell. Internal Revenue Service (IRS) guidelines state an applicant for tax-exempt status can demonstrate that a purchase from insiders does not exceed fair market value, for example, by disclosing the purchase price or providing an independent appraisal report to support it, among other types of evidence. According to regulations, paying more than fair market value for assets sold by insiders would result in improper benefit and be grounds for IRS to deny the applicant's application for tax-exempt status.

Source: GAO review of 26 C.F.R. §§ 20.2031-1(b) and 53.4958-4(b)(1)(i) and IRS documents | GAO-21-89

We found that IRS staff reviewing for-profit college applications for tax-exempt status did not always seek information to assess whether insiders would improperly benefit from for-profit college conversions—specifically by being paid more than fair-market value either for the college or for services they provided to the college. According to Treasury regulations, improper benefit would occur if a tax-exempt organization purchases assets from insiders for more than their fair market value. IRS officials stated that doing so would be grounds for IRS to deny an application for tax-exempt status (see sidebar). If an application for tax-exempt status discloses a for-profit conversion, IRS staff training materials instruct staff to carefully scrutinize the application to determine whether the conversion

transaction is consistent with fair market value.<sup>66</sup> Staff training materials also state and IRS officials confirmed that in some cases staff may need to seek additional information to make this assessment, such as copies of draft purchase agreements or independent appraisal reports.<sup>67</sup> Further, as part of a compliance strategy focused on tax-exempt organizations with a for-profit history, IRS distributed a staff information sheet stating that such organizations, including colleges, are at an elevated risk for improper benefit. Staff training materials also states that relationships between an applicant and a for-profit entity—such as a college and its for-profit service provider—may be vulnerable to abuse and require special attention to assure that transactions between the applicant and for-profit entity do not exceed fair market value.

We found that 10 of the 17 for-profit college conversions involving insiders in our review were disclosed in an application for tax-exempt status by a new nonprofit organization.<sup>68</sup> An additional planned for-profit college conversion involving insiders was also reported in an application

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<sup>66</sup>IRS staff instructions state that staff must consider the possibility of improper benefit whenever an applicant has engaged in a transaction with insiders. According to these instructions, in many cases, improper benefit can only be identified upon careful examination of documents, such as contracts, loan agreements, and sale or lease agreements. These instructions also state that while establishing the fair market value of certain assets, such as cash or securities, is straightforward, the task may be more challenging in other cases—such as when intangible assets are involved. Recognizing such difficulties, a memorandum opinion from the United States Tax Court stated that it viewed determining fair market value as assessing whether a transaction price is within a reasonable range of what could be considered fair market value. See *Anclote Psychiatric Center, Inc. v. Comm’r*, 76 T.C.M. (CCH) 175 (T.C. 1998).

<sup>67</sup>Until 2018, staff training materials directed staff to secure copies of all contracts and agreements with a for-profit entity that are referenced in an application for tax-exempt status and not already provided. However, a 2018 update to the Internal Revenue Manual stated that staff should limit such documentation requests to cases in which there are potential eligibility concerns and insufficient application information to assess whether requirements of tax-exempt status are met. Such an eligibility concern could include the potential that an applicant plans to pay more than fair market value for assets sold by insiders.

<sup>68</sup>Among the 10 conversions involving insiders that were disclosed in an application for tax-exempt status, we categorized nine as involving a new nonprofit purchaser. The final conversion involved a for-profit college that reincorporated as a nonprofit organization and applied to IRS for tax-exempt status directly.

for tax-exempt status, but ultimately did not occur.<sup>69</sup> In all 11 of the planned or completed conversions, the organization seeking to become tax exempt disclosed plans to purchase a for-profit college and retain former for-profit college owners or other officials in a leadership role in the newly tax-exempt college.<sup>70</sup> However, IRS staff did not always follow instructions to closely scrutinize the applications to assess whether the conversion transactions were consistent with fair market value. Such scrutiny is important because if the college's sale price was inflated beyond fair market value, then insiders would improperly benefit from the sale.

For nine of the 11 colleges, we found that the public IRS application filed by the college's purchaser either contained information IRS staff could use to assess the transaction (such as the purchase price or a copy of an independent appraisal report) or that IRS staff sought additional information needed to make this assessment before approving the applications. In one case, for example, IRS staff asked the applicant to provide a copy of a proposed purchase agreement and an independent appraisal report estimating the value of property to be included in the transaction.

However, for two of the 11 colleges, IRS staff approved the application for tax-exempt status without seeking sufficient information to assess whether the purchaser would pay insiders more than fair market value for the college. Both organizations were created expressly to purchase the college, but neither application included a planned purchase price or an independent appraisal report estimating the college's value. Instead, the applications stated that independent appraisals would be conducted in the future and that the purchase price, once determined, would not exceed fair market value. Each application also disclosed plans for the newly tax-exempt college to purchase extensive services through contractual agreements with its former owners. IRS training materials state that staff should carefully assess whether the contracts exceed the

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<sup>69</sup>We reviewed all available approved IRS applications for tax-exempt status as associated with for-profit colleges that applied to Education for nonprofit college status. We identified those applications that disclosed plans to acquire a for-profit college from insiders and assessed IRS's review of those applications. Because this objective focused on IRS's review process, our analysis included any application that disclosed plans to purchase a for-profit college from insiders, including any in which the tax-exempt organization did not subsequently purchase the for-profit college as planned.

<sup>70</sup> For the other seven of 17 colleges whose conversions involved insiders, the college was purchased by an existing organization that already had tax-exempt status at the time of the purchase.

fair market value of the services being provided. However, only one application disclosed how much the college planned to pay for services, and neither provided an independent appraisal report estimating the value of the services.

According to IRS officials, assurances from the applicants that independent appraisals would be conducted and that the eventual transaction prices would not exceed fair market value provided a sufficient basis for the agency's decision to approve these applications. Officials further noted that decisions to grant or deny tax-exempt status are based on representations provided by applicants, and that staff do not audit applicants before making their determination. However, each applicant had a for-profit history, which an IRS staff information sheet says poses a heightened risk of improper benefit. Further, each application disclosed significant planned transactions with insiders, which IRS staff instructions direct staff to assess carefully. Without seeking information recommended in guidance, such as the college's planned purchase price, price of contracted services, or independent appraisal reports establishing the value of the college or contracted services, IRS could not assess whether transactions in these cases would be fair and consistent with the requirements of tax exemption.<sup>71</sup> Ensuring appropriate application review in such cases is critical as it represents the earliest opportunity for IRS to identify and respond to the risk of improper benefit, particularly given that many years may pass before a tax-exempt organization may be selected for an audit.<sup>72</sup>

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<sup>71</sup>We evaluated whether sufficient information was available in application materials for staff to assess whether the transactions reported in applications for tax-exempt status were consistent with fair market value, as directed in staff training materials. We did not evaluate whether these planned transactions were actually consistent with fair market value. Further, because we focused on the steps IRS takes to identify and respond to the risk of improper benefit, we did not conduct an audit of any college in our review to determine whether insiders improperly benefitted from any conversion, nor did we assess the outcome of any decision IRS reached with respect to any application in our review. Per IRS procedures, all public application files, such as those we reviewed, should contain all information material to IRS's decision to approve the application, including any IRS staff correspondence with the applicant and any additional information provided by the applicant.

<sup>72</sup>We provided a list of 27 possible tax-exempt purchasers of for-profit colleges to IRS before confirming our final list of 20 tax-exempt purchasers. IRS officials confirmed that of these 27 tax-exempt organizations, nine had been audited from 2010 through 2018. However, due to privacy protections on taxpayer data, officials did not confirm whether any of the audits focused on improper benefit or disclose how long after the conversion transaction the audits occurred.

IRS officials said they rely on staff expertise to evaluate the unique facts and circumstances of each application for tax-exempt status. However, they also noted that for-profit conversions can raise complex technical issues with which even veteran staff may have limited experience.<sup>73</sup> Staff guidance and internal controls, such as manager reviews of staff decisions before they are finalized, are in place to help provide reasonable assurance that staff appropriately assess the risk of improper benefit in applications for tax-exempt status. However, IRS managers told us the depth of their reviews can vary greatly—from cursory to in-depth—depending on factors such as the complexity of the case, a manager’s confidence in the staff member’s abilities, and the staff member’s level of experience. IRS also has a quality assurance group that reviews a random sample of staff decisions to assess their quality. However, IRS officials said that this group has reviewed relatively few cases involving previously for-profit organizations, such as colleges.<sup>74</sup> This group can also select specific types of cases to review, but officials said they have not focused on previously for-profit colleges.<sup>75</sup>

The complexity of for-profit college conversions that involve insiders and the potential risk they pose heighten the importance of robust quality assurance practices. Standards for internal control in the federal government state that management should mitigate risks by periodically reviewing the effectiveness of internal control policies and procedures.<sup>76</sup> However, IRS officials stated that they have not assessed whether the agency’s internal controls are sufficient to provide reasonable assurance that staff consistently follow guidance to evaluate the risk of improper benefit associated with for-profit college applications for tax-exempt status. Assessing whether internal controls are robust and effectively implemented would better position IRS to assure the quality and

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<sup>73</sup>According to IRS officials, staff evaluating applications for tax-exempt status do not specialize in reviewing specific types of taxpayers (such as previously for-profit colleges). However, more senior staff members are typically assigned to review complex applications.

<sup>74</sup>According to IRS officials, the quality assurance group randomly selects a small, but statistically valid, sample of all approved applications for review.

<sup>75</sup>IRS officials stated that staff also have the option to immediately refer recently approved tax-exempt organizations for audit if staff have concerns about possible future noncompliance, but insufficient information to deny the application. IRS officials told us they rarely refer recently approved tax-exempt organizations for audit.

<sup>76</sup>[GAO-14-704G](#).

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consistency of IRS's decisions in such complex cases and improve the review process for conversion applications.

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## IRS Does Not Collect Sufficient Information to Identify Previously For-Profit Colleges with Tax-Exempt Status for Oversight Purposes

To oversee existing tax-exempt organizations, IRS conducts audits of organizations at risk of noncompliance with tax law.<sup>77</sup> However, IRS does not collect the information it needs to systematically identify tax-exempt organizations with a for-profit history, such as colleges, for potential audit. Ten of 17 conversions involving insiders in our review were disclosed in an application for tax-exempt status and IRS reviewed the planned conversion transactions as part of its application approval process. However, the other seven of 17 conversions in our review that involved insiders were not reported in an application because the college's purchaser was already tax exempt. As a result, IRS did not have the opportunity to consider these conversions as a part of its decision to grant the purchaser tax-exempt status.

According to IRS officials, the agency could review conversion transactions that involve an already approved tax-exempt organization if the organization is selected for audit. However, to do so systematically, IRS would need to collect information enabling it to identify when an approved tax-exempt organization has engaged in such a conversion transaction. To select organizations for audit, IRS relies to a large extent on information organizations report in their annual filing—specifically information in searchable data fields.<sup>78</sup> However, this form does not have a data field that asks whether a tax-exempt organization has purchased a for-profit entity or otherwise has a for-profit history. By contrast, IRS's application for tax-exempt status does ask whether an organization has a for-profit history—specifically, the form asks whether the applicant has taken over the assets or activities of a for-profit entity or whether the

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<sup>77</sup>According to agency procedures, IRS also conducts other compliance activities to oversee existing tax-exempt organizations, such as compliance strategies.

<sup>78</sup>IRS Form 990, *Return of Organization Exempt From Income Tax*. According to agency audit procedures, IRS also makes audit selections based on referrals from internal IRS offices and external sources, such as state attorneys general. In fiscal year 2019, IRS reported that about half of audits were selected using methods that relied on searches of data fields on an organization's annual Form 990.

applicant has converted from for-profit to nonprofit status.<sup>79</sup> Already approved tax-exempt organizations may disclose that they have purchased a for-profit entity, such as a college, from insiders in narrative fields in their annual filing. However, IRS officials stated that narrative fields are not generally used for audit selection because they are not easily searchable. The lack of information in easily searchable data fields means IRS cannot systematically select for audit tax-exempt organizations whose annual filings disclose purchasing a for-profit college from insiders—such as the organizations that purchased seven colleges in our review.

This lack of information has hampered IRS's oversight efforts. For example, IRS has implemented a new compliance strategy with the goal of identifying tax-exempt colleges and other organizations that have been part of a for-profit conversion, due to their heightened risk of improper benefit.<sup>80</sup> Because IRS has minimal data on tax-exempt organizations with a for-profit history, it used complex data matching techniques to try to identify them. However, these techniques did not identify any of the existing tax-exempt organizations that purchased the seven for-profit colleges from insiders in our review.<sup>81</sup> IRS officials also said that while it may be possible for them to search narrative fields if necessary, variation in wording used in narrative fields could hamper their ability to identify such cases for audit. Without the ability to easily identify previously for-profit colleges and other tax-exempt organizations with a for-profit history, IRS cannot systematically select them for audit and other compliance activities.

Though IRS could require tax-exempt organizations to report the purchase of a for-profit college or other for-profit entity in a data field on the annual IRS filing, it has not done so. IRS officials stated that doing so was unnecessary since the agency's application form for tax-exempt

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<sup>79</sup>As of January 2020, IRS moved this application form online, which would allow the agency to use this information to track new organizations that disclose plans to purchase a for-profit college in their application. However, this information does not help IRS to identify existing nonprofit organizations that purchased a for-profit college after obtaining tax-exempt status.

<sup>80</sup>The agency began developing this strategy due to concerns about for-profit college conversions, but broadened it to include all for-profit entity conversions that involved tax-exempt organizations, without regard to the organization's tax-exempt purpose.

<sup>81</sup>The compliance strategy did identify other tax-exempt organizations with a for-profit history that did not involve for-profit college conversions.

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status asks applicants whether they have a for-profit history. However, an existing tax-exempt organization does not need to submit a new application form when it purchases a for-profit college. As a result, IRS lacked information about the for-profit history for seven of the 17 colleges in our review because they were purchased by an existing tax-exempt organization. Standards for internal control in the federal government state that agencies should use quality information to make decisions.<sup>82</sup> Improving IRS's ability to identify previously for-profit colleges and other tax-exempt organizations with a for-profit history could enhance its oversight and reduce the risk that potential improper benefit and other tax noncompliance may go undetected.

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## While Education Is Reviewing Nonprofit Applications More Closely, It Has Not Taken Steps to Assess the Risk of Improper Benefit among Newly Converted Colleges

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### Education Has Enhanced Its Reviews of For-Profit College Applications for Nonprofit Status

In recent years, Education has enhanced its process for reviewing applications from for-profit colleges seeking to convert to nonprofit college status.<sup>83</sup> According to agency records, from November 2010 through August 2020, 59 for-profit colleges, which were part of 20 separate conversion transactions, applied to Education for nonprofit college

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<sup>82</sup>[GAO-14-704G](#).

<sup>83</sup>Education treats previously for-profit colleges participating in federal student aid programs (including those with IRS tax-exempt status) as for-profit until the department approves them for nonprofit status. For this reason, in this section we refer to all colleges without Education's approval as for-profit, even if they have been granted tax-exempt status by the IRS.

status.<sup>84</sup> As of August 2020, Education has approved 35 of these 59 colleges for nonprofit status and denied two.<sup>85</sup> The remaining applications are still under review or no longer require action because the colleges have closed (see figure 11). According to agency officials, Education's earlier reviews of for-profit college applications for nonprofit status involved ensuring that the college had the appropriate approvals from IRS, state oversight agencies, and accreditors, and that the college was financially responsible. While improper benefit is prohibited under the Higher Education Act for nonprofit colleges, agency officials noted that Education's earlier reviews did not focus on assessing the risk of improper benefit.<sup>86</sup> Officials told us that Education strengthened its approach in response to an application that raised agency concerns about the risk of improper benefit.<sup>87</sup> Our group of five case study colleges

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<sup>84</sup>These 59 colleges were acquired by 20 separate tax-exempt organizations. In most cases (15 of 20), just one college was acquired. However, in five cases, the tax-exempt organization purchased more than one college—up to 20 colleges in one case. In such cases, Education may conduct one conversion review for all colleges in the group. In addition, two of the 59 colleges were purchased by an existing nonprofit college and applied to merge with the nonprofit college, rather than applying to be recognized as nonprofit colleges themselves; the colleges then became additional locations of the nonprofit college that purchased them. According to Education officials, different regulatory requirements applied to these two colleges, compared to other cases in our review. In particular, because the nonprofit college purchasers did not experience a change in ownership or control, they were not required to participate in federal student aid programs on a provisional basis following the transaction. However, to qualify as an additional location, the colleges being purchased would be required to satisfy many of the same requirements as the other for-profit colleges in our review. See 34 C.F.R. §§ 600.20, 600.31, and 34 C.F.R. 600.32.

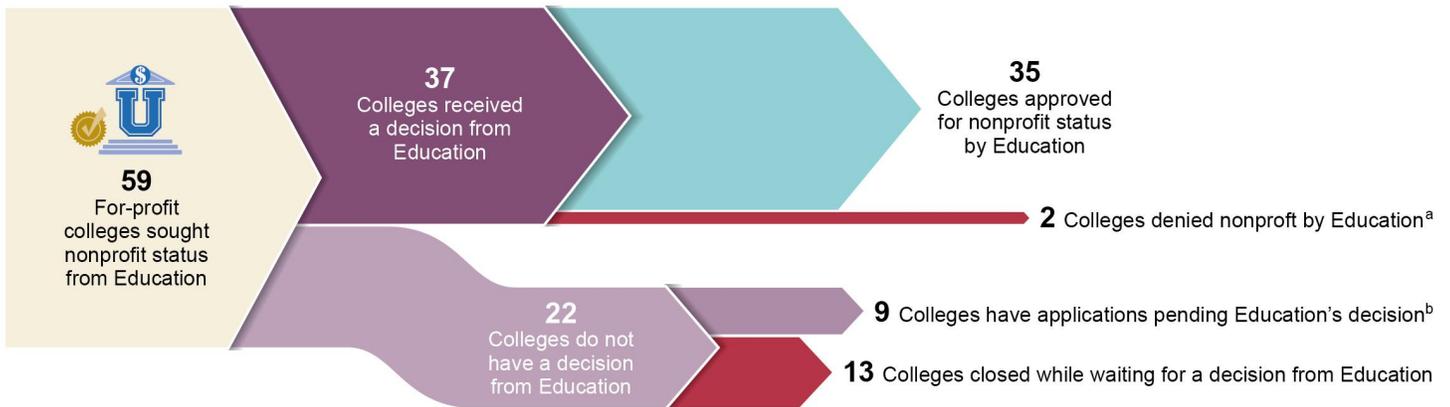
<sup>85</sup>Of these 35 approved colleges, 13 converted with insiders involved and 22 did not. Of the two colleges whose applications for nonprofit college status Education denied, one involved insiders and the other did not. Education denied one college's application for nonprofit college status citing concerns that it was created to improperly benefit its former for-profit owner. In the other case, Education revoked the college's authorization to participate in federal student aid programs and denied its application for nonprofit college status due to its failure to pay federal student aid funds owed to students, among other concerns. In 2016, Education denied an application for nonprofit status from four related colleges whose conversion transactions involved insiders, but later approved the colleges for nonprofit status following the resolution of key agency concerns. These four colleges are included in GAO's count of 35 colleges approved for nonprofit status by Education and excluded from GAO's count of colleges denied for nonprofit status.

<sup>86</sup>Under the Higher Education Act, no part of a nonprofit college's net earnings may improperly benefit any private individual. See 20 U.S.C. § 1003(13).

<sup>87</sup>According to Education officials, the agency's approach to evaluating for-profit college applications evolved due to their review of this application.

included two colleges that Education approved for nonprofit college status prior to this change and one college approved after it.<sup>88</sup>

**Figure 11: Application Status of For-Profit Colleges That Completed Conversion Transactions between January 2011 and August 2020 and Applied to Education for Nonprofit College Status as of August 2020**



Source: GAO analysis of Department of Education documents. | GAO-21-89

Notes: In this report, we use the term for-profit college conversion to refer to a college's transition from for-profit ownership to ownership by a nonprofit organization recognized by IRS as tax-exempt. The college must separately apply to Education for nonprofit college status. See 20 U.S.C. §§ 1003(13) and 1094(a).

The 59 colleges in GAO's review were part of 20 separate conversion transactions. Most of these transactions (15 of 20) involved just one college. However, five of the 20 conversion transactions involved the sale of multiple for-profit colleges to a single tax-exempt organization. In such cases, Education may conduct one conversion review for the entire group. In addition, two of the 59 colleges were purchased by an existing nonprofit college and applied to merge with the nonprofit college, rather than applying to be recognized as nonprofit colleges themselves.

<sup>a</sup>In 2016, Education denied an application for nonprofit status from four related colleges, but later approved the colleges for nonprofit status following the resolution of key agency concerns. These four colleges are included in GAO's count of 35 colleges approved for nonprofit status by Education and excluded from GAO's count of colleges denied for nonprofit status.

<sup>b</sup>These colleges continue to participate in federal student aid programs as for-profit colleges.

Education officials explained that prior to 2016 the agency did not have well-developed guidance or a specialized work group to evaluate complex changes in ownership and nonprofit conversions. In line with this observation, we found that staff did not identify or follow up on potential risks of improper benefit in either of the case study colleges whose

<sup>88</sup>The other two case study colleges we selected for in-depth review were pending Education's decision at the time we selected them. As a result, we did not evaluate Education's review of these cases.

conversions Education approved prior to 2016.<sup>89</sup> In both cases, former for-profit owners held leadership roles in the college's tax-exempt purchaser both before and after selling the college, putting them in a position to possibly influence the sale and the college's subsequent financial decisions for their own improper benefit. However, Education staff did not focus on assessing the risk of improper benefit in either case. Education staff familiar with both reviews noted that leadership continuity following a change in ownership can enhance a college's operational stability and suggested they did not see leadership by former owners as a source of risk. Further, Education staff did not request or review independent appraisal reports or thoroughly assess purchase and sale agreements to determine whether former owners were paid more than fair market value for either college. For one of these cases, Education staff told us that they would not have questioned whether the college sale price was fair. For the other case, staff said they had no process to assess the fairness of the college sale price nor a way to assess whether the former owner had improperly influenced the price.

According to Education officials, under the new process the agency began developing in 2016, Education started requesting copies of documents, such as a list of the new tax exempt college's board of directors, purchase and sale agreements, and independent appraiser reports, to assess whether the sale price was fair and did not improperly benefit insiders. According to officials, Education also began requesting copies of other agreements between the college and its former for profit owners, including employment contracts and lease agreements to determine if the college employed, or leased property from, insiders and to assess whether the terms of these transactions were reasonable. Education reviewed the application for one of our case study colleges after 2016 and obtained additional information, such as lease and debt terms, during the course of the review. According to an official involved in the review, Education used this information to assess whether the former owners were benefitting improperly from those agreements. More recently, Education officials told us that the agency has started to use templates to standardize its document requests and help ensure that staff

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<sup>89</sup>Because we did not conduct an audit of any college in our review to determine whether insiders improperly benefitted from any conversion, we did not assess whether Education reached the appropriate decision with respect to any college's application for nonprofit status in our review. According to Education officials, the agency reviewed and approved seven separate conversion transactions that included 30 colleges in our review before it began reviewing conversion applications more thoroughly in 2016. Since that time, Education has approved five additional colleges for nonprofit college status and denied two.

consistently collect information needed to assess the risk of improper benefit.

Education took additional steps to improve its processes when it created a centralized team composed of Education staff with contract review, finance, and legal expertise. According to officials, the agency created this team in September 2018 to help staff review applications from for-profit colleges seeking nonprofit status and identify risks of improper benefit.<sup>90</sup> Officials noted they are also working to obtain contractor assistance to assess valuation reports provided by applicants. Officials further explained that the team has begun to work closely with staff in regional offices to review for-profit college applications for nonprofit status and draft decision letters, which are then finalized by the regional director. Officials stated that the team is currently involved in all ongoing agency reviews of pending for-profit college applications for nonprofit status and that since this centralized team started reviewing applications, the agency has issued one decision regarding a for-profit college's application to convert to nonprofit status. Education's review of this application included a detailed consideration of the fairness of the sale price, a former owner's continuing role in the college, and the independence of the college's board, among other things.<sup>91</sup> As a result of these actions, Education may be better positioned to thoroughly evaluate for-profit college applications for nonprofit status and mitigate the risk of improper benefit.

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### Education Is Taking Steps to Ensure That Colleges That Submit an Application for Nonprofit College Status Do Not Advertise as Nonprofit While the Decision Is Pending

We found that for-profit colleges advertised as nonprofit colleges while Education was reviewing their applications for nonprofit college status; however, according to agency officials, Education is in the process of

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<sup>90</sup>When colleges participating in federal student aid programs change ownership, they must notify and secure approval from Education to continue their participation. According to officials, the centralized team focuses on all change in ownership applications, including those related to a for-profit college seeking to become a nonprofit college.

<sup>91</sup>While this was not one of our three case studies with Education approval, we reviewed a public letter from Education that provided a detailed description of its denial decision. Its review noted that the terms of the contract for the nonprofit college to purchase a range of services from the former owner would benefit the former owner and stakeholders—which would be inconsistent with the Higher Education Act's prohibition against private individuals benefiting financially from a nonprofit college.

communicating newly developed instructions to colleges with such pending applications to prohibit advertising that could be confusing to students. A for-profit college seeking to convert to nonprofit status must have IRS tax-exempt status prior to obtaining nonprofit college status from Education.<sup>92</sup> Education considers the college to be a for-profit college until it has reviewed and approved the college's application for nonprofit college status. A college with a pending application must continue to meet all Education requirements applicable to for-profit colleges.<sup>93</sup> Some experts on student college choice suggest that students may want to consider whether a college is a nonprofit, for-profit, or public institution when choosing a college to attend, because a college's status can have different implications in terms of cost, perceived reputational benefits, and transfer of credits, among other things. If a tax-exempt college advertises as nonprofit without being clear as to what this means, students may erroneously believe that the college is approved by Education as a nonprofit college—and, as a result, they may not have accurate information upon which to make their decision.

We found that the nine for-profit colleges with pending applications for nonprofit college status at the time of our review all advertised as nonprofit colleges before Education decided whether to approve or deny their applications. In addition to the colleges with pending applications, we also reviewed past advertising for three additional colleges with available information—one of our three Education case study colleges and both colleges whose applications Education later denied—and found that all three had advertised as nonprofit before Education had made a decision on their applications.<sup>94</sup> For instance, one college issued a press release the day after it obtained tax-exempt status from IRS, stating that it was now a nonprofit tax-exempt educational institution and that its conversion had been conducted in accordance with “the requirements of the U.S. Department of Education.” The college issued the press release more than 3 years before it obtained nonprofit status from Education, an extended period during which students enrolling in the college may have

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<sup>92</sup>See 34 C.F.R. § 600.2.

<sup>93</sup>See 34 C.F.R. §§ 600.31, 668.13, and 668.14

<sup>94</sup>For the other two case study colleges with Education approval, we were unable to find advertising information corresponding to the periods during which their applications were pending.

had a mistaken understanding about whether they were pursuing a degree from a college recognized by Education as a nonprofit.

Education officials have acknowledged concerns about unclear language in colleges' advertisements while their applications are under review. One official noted that it is fair for a college to advertise that it has tax-exempt status, but broader statements about a college having nonprofit status can make it unclear whether or not the college has Education's approval.<sup>95</sup> In a denial letter to one for-profit college seeking nonprofit status, Education noted that the college's advertisements referring to itself as a nonprofit college are confusing and could cause students and others to incorrectly assume that the department considered it to be a nonprofit college. Education instructed the college to stop advertising as a nonprofit.

Education recently developed instructions to prohibit for-profit colleges with pending applications from advertising as nonprofit colleges<sup>96</sup> (see text box). Agency officials said they plan to provide these instructions to all for-profit colleges that apply for nonprofit college status. Specifically, they explained that the agency would include the advertising instructions in its document request and decision letters for nonprofit status, as well as in the temporary program participation agreements that allow colleges with pending applications to continue to receive federal student aid while Education reviews their applications. To ensure that schools that currently have pending applications for nonprofit college status are aware of the new advertising instructions, Education officials told us that they intend to send a separate letter with the instructions to these colleges no later than October 15, 2020. Providing these advertising instructions to colleges should help Education curtail this type of potentially confusing advertising and ensure that students have clear and accurate information upon which to base their educational decisions.

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<sup>95</sup>Federal student aid regulations prohibit colleges from engaging in substantial misrepresentation in their marketing and advertising. See 34 C.F.R. § 668.71(b). We did not conduct a legal analysis to assess whether the advertising of any college complied with these regulations because we focused on Education's efforts to identify and respond to the risk of improper benefit.

<sup>96</sup>Education officials noted that the agency cannot restrict colleges from referring to their tax-exempt status conferred by the IRS.

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**Education’s Advertising Instructions to Colleges with Pending Applications for Nonprofit College Status**

The Department [of Education] does not take a position with respect to [college owner name’s] tax-exempt 501(c)(3) status with the Internal Revenue Service. [College name] must refrain from identifying itself as a “nonprofit institution” in any advertising, publications, or other notifications unless and until the Department approves the request to convert to nonprofit status. Use of the term “nonprofit” would be confusing to students and the public, who may interpret it to mean that the Department has already approved the institution as a nonprofit under its regulations. The Department does not take a position regarding statements that [college name] may make about its IRS status as a 501(c)(3) tax-exempt organization.

Source: Education document; language in brackets added by GAO. | GAO-21-89

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**After Approval, Education Does Not Review College Financial Statements to Identify Potential Risk Indicators for Improper Benefit among Converted Nonprofit Colleges**

Some indicators of potential improper benefit may surface in a college’s audited financial statements after Education has approved the college for nonprofit status; however, Education does not use its existing reviews of college financial statements to assess this risk. The Higher Education Act requires all colleges to submit their audited financial statements to Education on an annual basis, and Education uses information in those statements to calculate the colleges’ financial responsibility composite score, a measure of college financial health.<sup>97</sup> According to Education officials, while a contractor reviews the financial statements of all colleges to calculate the composite score, Education staff conduct audited financial statement reviews only for certain colleges, such as colleges with a failing score, as well as colleges overseen by Education’s multiregional division (typically large for-profit colleges). Further, even when staff review a previously for-profit college’s full audited financial statements, they do not assess whether the statements contain indicators of potential improper benefit.

Colleges are required to disclose information in their audited financial statements that could provide Education with important insights into possible improper benefit. For instance, in accordance with accounting standards, colleges must disclose losses on intangible assets they

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<sup>97</sup>See 20 U.S.C. § 1099c(c) and 34 C.F.R. § 668.23(d).

purchased and related-party transactions.<sup>98</sup> These could include transactions such as leases or contracts with insiders, as well as related-party debt.

We reviewed audited financial statements for each of our three case study colleges approved by Education for nonprofit college status. In two cases, we found information in the colleges' audited financial statements that could raise concerns about possible improper benefit.<sup>99</sup> For example, one college advanced funds to another business controlled by its former owner and later purchased assets from that business, all while the former owner continued to lead the college as its president. Although transactions between a nonprofit college and related parties (such as companies controlled by the college's president and former owner) are not prohibited, they can indicate a risk that a college's resources may have been improperly used for the former owner's benefit. This college's financial statements also showed that the college recognized a substantial loss on the intangible assets acquired when the college was purchased from its former owner about 3 years earlier.<sup>100</sup> While such a loss may arise for unforeseen reasons (i.e., shifting market conditions), it could also indicate that the college and its assets were knowingly overvalued at the time of the sale to improperly benefit insiders. Education staff in the region that managed this case told us that they were aware that the college had recognized a loss on intangible assets (as it had affected the agency's evaluation of the college's financial condition).<sup>101</sup> However, staff also said that they had not considered whether the loss reflected a risk of improper benefit. Further, a staff person involved in the review said that he believed the former owner was mostly retired and uninvolved in college operations, but we found the former owner was still the college president at the time of our review.

According to Education officials, the agency has not developed plans to assess the financial statements of newly approved nonprofit colleges for

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<sup>98</sup>Financial Accounting Standards Board, Accounting Standards Codification 350-30-50-3 and 850-10-50-1.

<sup>99</sup>We analyzed audited financial statements from the time of a for-profit college's sale to tax-exempt owners through fiscal year 2018.

<sup>100</sup>Specifically, the college reduced the value of the intangible assets on its balance sheet and reported a corresponding loss on its income statement, recognizing that it did not expect to benefit from the costs it had incurred to purchase those assets.

<sup>101</sup>Agency officials noted that the college was subject to heightened financial monitoring due to failing composite scores during this period.

indicators of possible improper benefit, even though we found they may contain new and relevant information about potential risks. One official stated that reviewing financial statements to assess such risk is not required in regulation and that all nonprofit colleges should be treated equally once they obtain Education's approval. However, according to procedures, after Education's approval newly converted nonprofit colleges are provisionally authorized to receive federal student aid funds generally for a period of 1 to 3 years, during which time colleges should be monitored more closely. Further, unlike colleges with a long history of nonprofit status, audited financial statements submitted by newly nonprofit colleges may contain important information about potential risks of improper benefit in the early years of its nonprofit operation.

Education officials stated that it would be reasonable for the agency to assess the risk of improper benefit as a part of its annual audited financial statement review process after it has approved a college for nonprofit status. Officials said that they could develop relevant procedures to ensure that its reviews of audited financial statements looked for potential improper benefit by former college owners and that they could refer any concerns identified to Education's centralized review team for further review. Until such procedures are in place and are implemented for all newly converted nonprofit colleges, Education lacks reasonable assurance that staff will review the financial statements of newly converted nonprofit colleges following their approval to assess risks of improper benefit. As a result, Education may miss opportunities to more effectively monitor such colleges after their approval.

The Higher Education Act prohibits the revenues of nonprofit colleges that receive federal student aid funds from being used to improperly benefit private individuals.<sup>102</sup> Standards for internal control in the federal government state that agency management should design control activities to achieve objectives and respond to risks.<sup>103</sup> Without procedures in place for reviewing audited financial statements to look for indicators of improper benefit at converted nonprofit colleges, Education lacks reasonable assurance that federal student aid funds are used appropriately and do not improperly benefit insiders.

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<sup>102</sup>See 20 U.S.C. § 1003(13).

<sup>103</sup>[GAO-14-704G](#).

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## Conclusions

If a nonprofit college's revenues are diverted to improperly benefit insiders, funds available to support the college's educational mission would be reduced, potentially harming the college and violating federal requirements. IRS has stated in a staff information sheet for a compliance strategy that tax-exempt organizations with a for-profit history, such as colleges, may pose a heightened risk of improper benefit. While IRS provides staff with guidance to assess the risk of improper benefit by evaluating whether transactions reported on applications for tax-exempt status are consistent with fair market value, we found that IRS staff did not always seek the information to thoroughly assess this risk when reviewing for-profit college applications for tax-exempt status. Further, IRS has not assessed its internal controls to assure that staff consistently evaluate for-profit college applications for tax-exempt status to determine whether their conversion transactions are consistent with fair market value and do not improperly benefit insiders. Assessing and, as applicable, improving these controls could help IRS assure that any improper benefit is detected and prevented prior to granting tax-exempt status. Once tax-exempt status is granted, however, IRS does not have the information it needs to systematically identify and monitor previously for-profit colleges' compliance with the requirements of that status. Collecting such information—for instance, on annual filings required for tax-exempt organizations—could help IRS respond proactively to risks that some insiders could improperly use the resources of a tax-exempt college for their own personal benefit.

Education has recently enhanced its scrutiny of previously for-profit college applications for nonprofit status and improved its oversight of for-profit college conversions. However, until Education extends its review beyond the initial approval of nonprofit applications, the agency may miss indicators of improper benefit that surface in audited financial statements after a college's nonprofit approval. As for-profit colleges continue to convert to nonprofit status, Education has the opportunity to better assure that converted colleges continue to act in accordance with the requirements of their nonprofit status.

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## Recommendations for Executive Action

We are making a total of three recommendations, including two to IRS and one to Education. Specifically:

- The Commissioner of Internal Revenue should assess the agency's internal controls for reviewing for-profit college applications for tax-exempt status and improve the review process to ensure that staff appropriately apply agency guidance on assessing potential improper benefit to insiders. (Recommendation 1)
- The Commissioner of Internal Revenue should collect information, for instance on the annual IRS filing tax-exempt organizations are required to submit, that would enable the agency to systematically identify tax-exempt colleges with a for-profit history for audit and other compliance activities. (Recommendation 2)
- The Secretary of Education should develop and implement monitoring procedures for staff to review the audited financial statements of all newly converted nonprofit colleges for the risk of improper benefit. (Recommendation 3)

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## Agency Comments and Our Evaluation

We provided a draft of this report to IRS and Education for review and comment. Their comments are re-produced in appendix II and appendix III, respectively, and summarized below. IRS also provided technical comments, which we incorporated as appropriate. We also provided relevant information to representatives of the five case study colleges for their technical review and incorporated their technical comments as appropriate.

In response to the first recommendation, IRS stated that it would assess its internal controls for reviewing applications for tax-exempt status from organizations with a for-profit history and make improvements to those controls, as appropriate. In addition, IRS stated that it would continue to educate staff on application review procedures, emphasize staff discretion to request additional information from applicants, and provide staff with sample questions about transactions with for-profit entities. IRS also noted that we reviewed 11 applications for tax-exempt status that disclosed plans to purchase a for-profit college from insiders between January 2011 and August 2020, while over the same time period IRS processed over 700,000 applications for tax-exempt status. We acknowledge that applications for tax-exempt status stemming from a for-profit college conversion represent a very small proportion of IRS's total caseload. However, as acknowledged by IRS, such conversions pose a heightened risk of improper benefit. Further, in two of the 11 cases we

reviewed, applicants did not provide sufficient information for IRS staff to determine whether the transactions were consistent with fair market value so that staff could assess the risk of improper benefit to insiders, as instructed in IRS guidance. While this guidance gives staff discretion to determine whether additional information is needed to assess if an applicant will pay more than fair market value to purchase assets from insiders, we continue to believe that without knowing the prices the applicants planned to pay insiders in these high risk cases, IRS staff were not well positioned to assess whether the prices were consistent with fair market value. We believe that a broader review of IRS's internal controls would help assure that staff appropriately apply guidance in these high-risk cases.

In response to the second recommendation, IRS stated it would evaluate the benefits and burdens of collecting information about the for-profit history of tax-exempt organizations, including colleges. IRS noted that it already asks tax-exempt organizations to report whether they have engaged in transactions with insiders. However, responses to this question do not allow IRS to isolate organizations that have engaged in conversion transactions with insiders. As a result, IRS does not have the information it needs to systematically identify and audit approved tax-exempt organizations with a for-profit history—in particular, those that have engaged in for-profit conversion transactions with insiders. IRS's compliance strategy acknowledges that these transactions pose unique risks. However, the matching techniques IRS used in the strategy to identify tax-exempt organizations that were involved in a for-profit conversion did not identify any existing organization that purchased a for-profit college from insiders. Although IRS states that its techniques were not designed to identify for-profit college conversions specifically, they were the original impetus for IRS's strategy and were included in the scope of its review. We continue to believe that IRS should collect additional information to enable it to systematically identify organizations with a for-profit history—organizations that the agency acknowledges pose a heightened risk of improper benefit—for oversight purposes.

In its written comments, Education agreed with the recommendation to develop and implement monitoring procedures for newly converted nonprofit colleges and noted the need to closely monitor such colleges for the risk of improper benefit during their provisional certification period. The agency stated that it will develop new financial analysis procedures to ensure that staff review audited financial statements submitted by newly converted colleges after Education's approval. Education also stated that it will include additional reporting requirements for newly

converted colleges as a condition in their provisional program participation agreements and it will closely monitor newly converted nonprofit colleges for the risk of improper benefit until the school receives its first recertification after the nonprofit conversion. For example, newly approved colleges will be required to report relevant IRS actions, changes to any existing service agreements between insiders and the college, and any new servicing or contracting agreements, among other things. Once implemented, we believe that Education's planned actions will help it identify indicators of potential improper benefit that can surface in audited financial statements after a college's nonprofit approval.

In its written comments, Education also provided several clarifications. Education observed that, in some cases, multiple colleges with a single owner were sold to the same nonprofit organization in a single conversion transaction. Education noted that while our analysis focused on the 59 colleges that converted to nonprofit status, the agency reviewed fewer than 59 transactions. In our draft report, we used colleges as our unit of analysis, but we did include information on the number of nonprofit organizations that acquired these 59 colleges. In response to Education's comments, we have clarified how college groups are treated in Education's application process and have included additional information to make it clear that Education did not review 59 separate conversion transactions. We have also added supplemental information on the number of unique conversion transactions associated with the colleges we report on in some sections of the report. Education also noted, in regards to our analysis of financial responsibility composite scores, that in the case of a group of colleges with the same owner, the agency only conducts one financial review for the group. We have added this information to the report. Finally, Education pointed out that two colleges in our review were purchased by existing nonprofit colleges and became an additional location of those colleges, rather than applying to be recognized as nonprofit colleges themselves. We believe that these colleges belong in our universe of for-profit college conversions, as they become part of a nonprofit college through a change in ownership and had to meet similar requirements to obtain Education's approval. We have clarified the information regarding these two colleges in the report and the applicable regulations for these colleges.

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As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies of this report to the Commissioner of Internal Revenue and the Secretary of Education, congressional committees, and other interested parties. In addition, this report will be available at no charge on the GAO website at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact me at (617) 788-0534 or [emreyarrasm@gao.gov](mailto:emreyarrasm@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix IV.

A handwritten signature in black ink that reads "Melissa Emrey-Arras". The signature is written in a cursive, flowing style.

Melissa Emrey-Arras  
Director, Education, Workforce, and Income Security Issues

# Appendix I: Objectives, Scope, and Methodology

This report examines (1) what is known about insider involvement in for-profit college conversions, (2) to what extent the Internal Revenue Service (IRS) identifies and responds to the risk of improper benefit associated with for-profit colleges that apply for and obtain tax-exempt status, and (3) to what extent the Department of Education (Education) identifies and responds to the risk of improper benefit associated with for-profit colleges that apply for nonprofit status, and those that successfully obtain nonprofit status, in federal student aid programs. This appendix provides details of the data sources used to answer these questions, the analysis we conducted, and any limitations to our analysis.

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## Overview

To describe what is known about insider involvement in for-profit college conversions, we first worked with Education to identify for-profit colleges that had applied to it for nonprofit college status and analyzed data on federal student aid funding provided to such colleges.<sup>1</sup> We then used public IRS information to identify the tax-exempt organizations connected with each for-profit college conversion. Once identified, we used the information we obtained from Education and IRS to describe characteristics of each conversion, including any involvement of insiders associated with the for-profit college. We then assessed the performance of all for-profit colleges that converted along key Education measures of financial health. Finally, we selected a risk-based sample of five case study colleges whose conversions involved insiders for more in-depth review, and compared details of their conversion transactions to those of five other randomly selected colleges whose conversions did not involve insiders.

To examine the extent to which IRS identifies and responds to the risk of improper benefit associated with for-profit colleges that apply for and

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<sup>1</sup>In this report, we use the term for-profit college conversion to refer to a college's transition from for-profit ownership to ownership by a nonprofit organization recognized by IRS as tax-exempt. The college must separately apply to Education for nonprofit college status. See 20 U.S.C. §§ 1003(13) and 1094(a).

obtain tax-exempt status, we reviewed federal laws, regulations, public IRS filings, and agency documentation, interviewed agency officials, and assessed staff reviews of applications for tax-exempt status against agency guidance and applicable federal internal control standards. We also assessed IRS efforts to identify previously for-profit colleges for oversight purposes against applicable federal internal control standards.

To examine the extent to which Education identifies and responds to the risk of improper benefit associated with for-profit colleges that apply for nonprofit college status and those that successfully obtain it, we reviewed federal laws, regulations, and agency documentation; interviewed agency officials; and reviewed staff evaluations of selected for-profit college applications for nonprofit college status and post-approval monitoring of those colleges. We assessed Education's post-approval monitoring practices against federal internal control standards for designing control activities to achieve objectives and respond to risks.<sup>2</sup>

We conducted this performance audit from September 2018 to November 2020 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Identifying For-Profit College Conversions

To describe what is known about insider involvement in for-profit college conversions, we first worked with Education officials to identify all colleges that have participated in federal student aid programs as for-profit colleges, sought Education's approval to change ownership and convert to nonprofit college status, and whose planned conversion transactions had occurred.<sup>3</sup> Because Education's management information system does not track such conversions, staff said they took several steps to identify these colleges. First, officials searched the

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<sup>2</sup>GAO-14-704G.

<sup>3</sup>For-profit colleges first became eligible to participate in federal student aid programs in 1972. Any for-profit college that became a nonprofit college prior to 1972 would have applied to Education to participate in federal student aid programs as a new nonprofit college and would not have submitted an application to change ownership and convert to nonprofit college status.

agency's management information system for all colleges coded in the system as nonprofit that also had a system flag indicating a past change in ownership. To determine which of those colleges were previously under for-profit ownership, they then compared this list to historical ownership data maintained by a contractor. The data Education provided in April 2019 indicated that the first applications for nonprofit college status submitted by colleges on this list were filed in November 2010, and the conversion transactions for these colleges occurred in January 2011. However, Education officials later identified an additional for-profit college conversion that occurred in 1995. Because we were completing our audit work, we did not include this 1995 conversion in the scope of our review. Education officials confirmed that no additional colleges completed their conversion transactions and applied to Education to become a nonprofit college or to merge with a nonprofit college as of August 2020. Therefore, the universe of for-profit college conversions included in our review spans January 2011 through August 2020. Each college in this universe corresponds with an institution of higher education that participated in federal student aid programs under a unique Office of Postsecondary Education identification number (OPEID). Some colleges may have multiple locations under one OPEID. In other cases, a group of colleges under common ownership may have multiple OPEIDs.

According to Education officials, after identifying all for-profit colleges with a prior approved conversion, they then worked with regional staff to manually develop lists of all for-profit colleges whose applications were still under agency review and for-profit colleges whose applications had previously been denied. The resulting full list of colleges with approved, pending, and denied conversion applications included each college's name OPEID, the name and tax identification number of the nonprofit organization that acquired each college, the date of each college's application, and the outcome of each application.

To verify the completeness and accuracy of the Education-compiled list, we compared it to other sources of information, including press and external organization reports about for-profit college conversions and other information from Education, such as details from the colleges' electronic change in ownership applications. A small number of colleges were added to the list and a few colleges were removed from it as a result

of these efforts.<sup>4</sup> In total, the final list included 59 for-profit colleges with completed conversion transactions that had an approved, pending, or denied Education application for nonprofit college status as of August 2020. We found the data to be reliable for the purpose of reporting the number of for-profit colleges that have undergone a conversion transaction and applied to Education for nonprofit college status and the dates and outcomes of their applications.

To describe funding provided to previously for-profit colleges, we analyzed Education data on federal student aid funding provided to the 59 colleges in our review for the 2018-2019 award year (the most recent year available at the time we conducted our analysis).<sup>5</sup> We reviewed the completeness of the data and confirmed steps taken to assure their reliability with Education officials. We determined these data to be reliable for the purpose of describing the amount of federal student aid funding provided to the colleges at the time we conducted our analysis.

We also sought public IRS information about the nonprofit tax-exempt organizations associated with the for-profit colleges that applied to Education for nonprofit college status. Because IRS was unable to identify these organizations itself, we provided IRS with a list of 29 tax-exempt organizations compiled from Education data.<sup>6</sup> We requested each organization's public application for tax-exempt status and annual IRS filings from the year before the conversion transaction through the most recent year available. We determined that 20 of the 29 tax-exempt organizations had acquired one or more of the 59 for-profit colleges in our

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<sup>4</sup>Specifically, we did not include in the scope of our review six for-profit colleges that had submitted applications for nonprofit college status to Education, but withdrew their applications because their planned sales ultimately did not occur. We also did not include ten for-profit colleges whose planned sales had not yet occurred as of August 2020. In addition, we excluded one for-profit college whose status changed as a result of an agreement to transfer the college's institutional assets, including its faculty and curricula, to an entity affiliated with a public university. The college was approved by Education to participate in federal student aid programs as a public college rather than a nonprofit college (on the condition that its debts and liabilities would be backed by the public university). While the college later applied for and obtained tax-exempt status from IRS, it continues to participate in federal student aid programs as a public college.

<sup>5</sup>Fifteen colleges closed prior to the 2018-2019 award year and were not included in this analysis.

<sup>6</sup>Specifically, IRS officials said the agency's data systems could not identify colleges that have been approved for tax-exempt status or tax-exempt organizations with a for-profit history.

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review, and included them in our review of what is known about for-profit college conversions.<sup>7</sup>

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## Describing For-Profit College Conversions

We then used the IRS documentation and other information, as needed, to summarize selected characteristics of each conversion.<sup>8</sup> First, we categorized each conversion based on features of the tax-exempt organization that acquired the college. Specifically, we used information contained in the IRS application for tax-exempt status and annual IRS filings to determine whether the tax-exempt organization was: (1) itself a reincorporated for-profit college, (2) a new nonprofit organization created to purchase the college,<sup>9</sup> (3) an existing nonprofit organization that was not itself a college,<sup>10</sup> or (4) an existing nonprofit college.<sup>11</sup>

Next, we assessed whether college officials were insiders to the conversion transaction. Specifically, we assessed whether (1) for-profit college owners, their family members, board members, or executives held board or executive roles in the college's nonprofit purchaser before the conversion transaction or (2) a for-profit college owner with a more than 35-percent ownership stake in the college assumed a nonprofit leadership

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<sup>7</sup>One of the 20 tax-exempt organizations in our review did not acquire the for-profit college. Instead, the for-profit college itself reincorporated as a nonprofit organization and applied to IRS for tax-exempt status.

<sup>8</sup>In a few cases, certain IRS documentation was not available. Specifically, two of the 20 tax-exempt organizations in our review obtained tax-exempt status more than 30 years ago, and their applications for tax-exempt status were not available. Annual IRS filings were not yet available for one of the 20 organizations, as it had obtained tax-exempt status in the recent past (IRS Form 990, *Return of Organization Exempt From Income Tax*). In three cases, we reviewed additional information included in tax-exempt organizations' requests to be reclassified as a school (IRS Form 8940, *Request for Miscellaneous Determination*).

<sup>9</sup>We coded organizations that disclosed their purchase of one or more for-profit colleges in an application for tax-exempt status as a new nonprofit organization.

<sup>10</sup>We coded organizations that disclosed their purchase of one or more for-profit colleges in an annual IRS filing as an existing nonprofit organization. If an existing nonprofit organization created a separate entity for the college purchase and the new entity reported the purchase on its application for tax-exempt status, we coded the college's purchaser as an existing nonprofit organization.

<sup>11</sup>We used Education information to corroborate whether the nonprofit purchaser was itself a nonprofit college.

role upon conclusion of the transaction.<sup>12</sup> We obtained this information from IRS applications for tax-exempt status and annual IRS filings submitted by the colleges' nonprofit purchasers. When needed, we also used other information, such as the colleges' applications to Education for nonprofit college status and their audited financial statements. Through our review, we identified 17 for-profit colleges that converted to tax-exempt status with insider involvement. Given the complexity of some conversions and possible limitations of the available information associated with them, we may not have identified all insider involvement in a for-profit college conversion.

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## Financial Condition of Colleges

To describe the financial condition of colleges before and after their conversion, we analyzed three Education metrics: the financial responsibility composite score, tangible net worth, and acid test ratio. The financial responsibility composite score is a combination of three ratios Education uses to measure the overall financial health of each nonprofit and for-profit college annually based on data from the colleges' audited financial statements.<sup>13</sup> Education considers a financial responsibility composite score of 1.5 or above to be passing, and a score below 1.0 to be failing.<sup>14</sup> Education considers colleges with failing composite scores not to be financially responsible and imposes additional restrictions on the colleges, such as letter of credit requirements or heightened cash monitoring. We reviewed each college's financial responsibility composite

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<sup>12</sup>IRS considers insiders to be private shareholders or individuals with a personal and private interest in a tax-exempt organization's activities who, by virtue of a special relationship with the organization, are able to influence the organization's financial decisions. See 26 C.F.R. § 1.501(a)-1(c). Further, IRS asks applicants for tax-exempt status to disclose transactions with any organization in which an insider owns a more than 35-percent ownership stake.

<sup>13</sup>Education uses slightly different formulas when calculating these ratios for nonprofit and for-profit colleges. See 34 C.F.R. § 668.172 and apps. A-B.

<sup>14</sup>Scores between 1 and 1.4 are passing, but are considered "zone" scores. Colleges with zone scores receive additional financial oversight. No college in our review had a zone score in the year before or year covering its conversion transaction.

score for the year before and the year covering its conversion transaction.<sup>15</sup>

Second, we reviewed each college's tangible net worth and acid test ratio after its conversion transaction.<sup>16</sup> Education calculates these metrics using data from a college's balance sheet as of the date of its change in ownership. A negative tangible net worth indicates that a college has insufficient tangible assets (such as cash, investments, and property) to cover its total debts. A failing acid test ratio means that a college does not have sufficient liquid assets (such as cash and incoming tuition payments) to cover debt that would be due within the following year. If a college has a negative tangible net worth or a failing acid test ratio, Education would require the college to provide a letter of credit to be considered financially responsible.

We assessed the reliability of these data by comparing them to data reported on the colleges' audited financial statements and, in some instances, performing our own calculations. We discussed data discrepancies with Education officials and worked with officials to correct data errors that we had identified.<sup>17</sup> We considered the final data set to be reliable for our purposes of describing Education's assessment of each college's financial condition as of the year before, the day of, and the year of its conversion transaction.

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## For-Profit College Conversion Case Studies

To better understand insider involvement in for-profit college conversions, we selected a judgmental, risk-based sample of five out of the 17 for-profit colleges we identified that converted to tax-exempt status with insiders involved. When making our case study selections, we also

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<sup>15</sup>One college's conversion transaction occurred in the recent past and its composite score was not yet available for the year of its conversion.

<sup>16</sup>In two cases, Education officials said tangible net worth and acid test ratio calculations were not required to be calculated because the colleges merged with an existing nonprofit college that already participated in federal student aid programs.

<sup>17</sup>Specifically, due to an administrative error, Education did not calculate a tangible net worth for 10 colleges following their conversion transaction. After GAO brought these errors to the attention of agency officials, they provided us with tangible net worth data for all but one of these 10 colleges. As a result of our efforts, officials acknowledged the errors and identified steps the agency should take to correct the system weaknesses that allowed them to occur.

considered Education's evaluation of the colleges' financial condition the year before and year of their conversion transaction and the amount of federal student aid funding the colleges received in the year before their conversion. Of the five colleges, three had received both IRS tax-exempt status and Education approval as nonprofit colleges at the time we selected them. In the other two cases, the colleges had obtained tax-exempt status from IRS, but their applications for nonprofit status were still pending with Education at the time we selected them.

For our five selected case study colleges, we reviewed sources, including the colleges' annual IRS filings and audited financial statements. We also collected information from college officials from the five case study colleges to better understand the circumstances of the conversion. Specifically we requested information from the college officials about the involvement of insiders in their conversion transaction; the reported benefits of insider involvement, potential risks, and safeguards implemented to mitigate those risks; the effect of the transaction on the college's financial condition; and the college's experiences obtaining IRS and Education approval, as relevant.<sup>18</sup>

For comparison, we also selected a random sample of five college conversions that did not involve insiders.<sup>19</sup> For both our case study colleges and the randomly selected colleges, we reviewed key audited financial statement information about the conversion transaction, including the proportion of assets sold that were intangible, the proportion of the sale price financed with debt, and who acted as lender (a bank or the college's former owner). We also reviewed Education data on the colleges' financial conditions from the most recent year available.

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<sup>18</sup>We posed the same questions to officials from a sixth college whose application for tax-exempt status is discussed in the report. Officials from this college responded to our information request.

<sup>19</sup>A GAO methodologist used a computer program to randomly select these five college conversions without insider involvement. Among the 59 conversions in our review, two were excluded from our insider analysis due to insufficient information or other special circumstances. We identified insider involvement in another 17 cases. Among the remaining 40 conversions without insider involvement, we removed from consideration for the comparison group colleges that had pending litigation regarding the college or other special circumstances. As a result, 25 conversions without insider involvement were eligible for selection. To avoid selecting multiple colleges sold to the same tax-exempt purchaser, we treated groups of colleges sold together as one conversion. Of the five conversions selected, one involved multiple colleges.

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The results of our case studies are not generalizable to all for-profit colleges that have sought nonprofit status. The case studies are solely illustrative of the types of conversions that have occurred and the potential risks and benefits of conversions with insiders involved.

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## IRS Review of Applications for Tax-Exempt Status and Monitoring of Tax-Exempt Organizations

We took a number of steps to assess the extent to which IRS identifies and responds to the risk of improper benefit associated with for-profit colleges that apply for and obtain tax-exempt status. To understand requirements for obtaining tax-exempt status, we interviewed agency officials and reviewed relevant documentation, including instructions for applying for tax-exempt status, and federal laws and regulations. To understand IRS standards for reviewing applications for tax-exempt status and selecting existing tax-exempt organizations for audit, we interviewed agency officials and reviewed Internal Revenue Manual procedures and staff training materials. Our interviews and document reviews focused on risk indicators of possible improper benefit (such as reporting transactions with insiders) and how staff should apply review standards when those risk indicators are present in an application for tax-exempt status (particularly with respect to colleges and other organizations with a for-profit history).<sup>20</sup>

We also identified IRS applications for tax-exempt status that disclosed plans to purchase a for-profit college from insiders and assessed IRS staff reviews of such applications. In total, we identified applications that disclosed plans to purchase 11 for-profit colleges from insiders, including one case in which the organization applying for tax-exempt status did not subsequently purchase the for-profit college as planned. We included this application in this analysis, which focused on IRS's processes for assessing such applications. In each case, we evaluated whether the applications had sufficient information for staff to assess whether the college sale price was consistent with its fair market value to ensure that the transaction did not improperly benefit insiders, as described in staff

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<sup>20</sup>Because IRS staff evaluate the facts and circumstances presented in each application for tax-exempt status, we also confirmed with IRS officials in writing common risk indicators of possible improper benefit (such as reporting transactions with insiders).

guidance. We also interviewed agency officials about their managerial and quality assurance review processes, and assessed these practices against federal internal control standards for reviewing procedures to address risk.<sup>21</sup> In recognition of taxpayer privacy protections, we did not interview IRS officials or review nonpublic documentation underlying any staff review of a specific application for tax-exempt status or audit of any specific tax-exempt organization in our review. Further, because we focused on the steps IRS takes to identify and respond to the risk of improper benefit, we did not conduct an audit of any tax-exempt organization in our review to determine whether insiders improperly benefitted from any conversion, nor did we assess the outcome of any decision IRS reached with respect to any application in our review.

To assess IRS's ability to monitor compliance of previously for-profit colleges with tax-exempt status, we interviewed IRS officials about their methods for identifying and selecting previously for-profit organizations, including colleges, for audit and other compliance activities. We reviewed data on which organizations in our review IRS identified through its ongoing compliance strategy on previously for-profit organizations. We assessed this information against federal internal control standards on using quality information to make decisions.<sup>22</sup>

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## Education Policies for Review of Conversion Applications and Monitoring of Nonprofit Colleges

To assess the extent to which Education identifies and responds to the risk of improper benefit associated with for-profit colleges that apply for, and those that obtain, nonprofit college status, we reviewed relevant federal laws and regulations, agency procedures for reviewing applications, and documents related to the colleges in our review, and we

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<sup>21</sup>[GAO-14-704G](#)

<sup>22</sup>[GAO-14-704G](#).

interviewed agency officials.<sup>23</sup> We reviewed case files for the three of five case study colleges whose applications for nonprofit college status had been approved by Education when we selected them.<sup>24</sup> We also interviewed Education officials involved in approving the applications for these three colleges. Because we focused on the steps that Education takes to identify and respond to the risk of improper benefit, we did not conduct an audit of any college in our review to determine whether insiders improperly benefitted from any conversion, nor did we assess the outcome of any decision Education reached with respect to any college's application for nonprofit status in our review.

To understand how colleges with pending applications for nonprofit college status advertised their status to prospective students, we reviewed the websites of the nine colleges with pending applications at the time of our review. We also reviewed case files of the three case study colleges that Education approved for nonprofit status for information about how they advertised while their applications were pending; however, advertising information was only available in one of the three case files. Finally, we also reviewed advertising information for two colleges whose applications for nonprofit status were denied by Education.

Finally, to assess the extent to which Education identifies and responds to the risk of improper benefit while monitoring newly converted nonprofit colleges, we reviewed agency procedures for post-approval monitoring and interviewed Education officials. We also analyzed the audited financial statements for the three case study colleges after they were approved for nonprofit status by Education. We assessed Education's post-approval monitoring of these colleges against federal internal control standards for designing control activities to achieve objectives and respond to risks and we reviewed Higher Education Act prohibitions on nonprofit college revenues being used to improperly benefit private individuals.<sup>25</sup>

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<sup>23</sup>For colleges whose applications Education approved or denied, we requested the application and the temporary program participation agreements for the period when their applications were under review. For colleges with pending applications, we requested temporary program participation agreements only. We used this information, as needed, to confirm details about the cases in our review.

<sup>24</sup>The two other case study colleges had nonprofit applications pending with Education when we selected our cases.

<sup>25</sup>[GAO-14-704G](#) and 20 U.S.C. § 1003(13).

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## Appendix II: Comments from the Internal Revenue Service

**Appendix II: Comments from the Internal Revenue Service**



DEPUTY COMMISSIONER

**DEPARTMENT OF THE TREASURY**  
INTERNAL REVENUE SERVICE  
WASHINGTON, DC 20224

November 6, 2020

Melissa Emrey-Arras  
Director, Education, Workforce, and Income Security Issues  
United States Government Accountability Office  
441 G Street, NW  
Washington, DC 20548

Dear Ms. Emrey-Arras:

Thank you for the opportunity to review the draft report of the Government Accountability Office entitled "**Higher Education: IRS and Education Could Better Address Risks Associated with Some For-Profit College Conversions**" GAO-21-89, (Job Code 103006). We appreciate your recognition that IRS collects information and maintains procedures to assess whether organizations attempting to convert to tax-exempt status comply with the applicable requirements of Internal Revenue Code (I.R.C.) section 501(c)(3). We share the goal of ensuring that applicants and staff appropriately apply these rules and procedures in every case.

GAO identifies 11 applications for recognition of tax-exempt status including the conversion of a for-profit college that involved "insiders" over the period from January 2011 through August 2020. During this period, IRS processed over 700,000 applications for recognition of I.R.C. section 501(c)(3) tax-exempt status. In two of the identified cases, GAO questions whether IRS sought "sufficient information to assess whether the nonprofit organization would pay insiders more than fair market value for the college." As noted in the report, IRS complied with applicable procedures to make a determination in these cases based upon the "facts, attestations, and representations contained in the administrative record" under Section 3.05 of Rev. Proc. 2020-5, 2020-1 I.R.B. 241 (updated annually). IRS guidance also instructs staff to closely scrutinize significant transactions between an applicant and its insiders to assure that they are consistent with fair market value, providing staff with the discretion to request an independent appraisal, where warranted. However, there is no requirement that specific information, such as an independent appraisal, be submitted during the determination process because every case rests on its own facts. In the two cases in question, the applications represented that an independent appraisal establishing a fair market value would be undertaken.

We believe our procedures were followed in the identified cases. Nonetheless, we appreciate GAO's study of this issue and constantly seek to improve our determinations process. We will continue to educate agents on the rules and procedures applicable to

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**Appendix II: Comments from the Internal Revenue Service**

for-profit conversions involving “insiders”, which, in particular, may raise questions as to whether the organization is complying with the requirement of Section 501(c)(3) that “no part of [its] net earnings ... inures to the benefit of any private shareholder or individual.” In addition, our training will emphasize to agents their discretion to request additional information from applicants, such as an independent appraisal, when indicated by the particular facts of the application. To support our agents in this regard, IRS has provided determinations agents with 70 pages of selectable paragraphs with questions on topics as varied as functional integration to fundraising and has included questions about transactions with for-profit entities. We will continue to train agents on the proper use of this resource.

GAO also suggests that IRS collect information on the Form 990-series annual information return that would identify whether an organization has a for-profit history to “help IRS respond proactively to risks that some insiders could improperly use the resources of a tax-exempt college for their own personal benefit.” We agree that there may be increased risk of inurement where an I.R.C. section 501(c)(3) organization, including but not limited to a tax-exempt college, engages in transactions with insiders. In fact, the Form 990 does ask whether the organization is a party to a business transaction (including a contract of sale) with certain interested parties, including current and former officers, directors, trustees, key employees, creators or founders, or substantial contributors. See Form 990, Part IV, line 28. Organizations answering yes then must provide additional information on Schedule L (Transactions with Interested Persons). The Form 990 also asks whether the organization owns a disregarded entity or is related to any taxable or tax-exempt entity in Part IV, lines 33 and 34, in which case additional information on Schedule R (Related Organizations and Unrelated Partnerships) is required. These questions assist in identifying organizations engaged currently in transactions or relationships with insiders that may indicate increased risk of inurement in the year for which the return is filed. In view of the entire population of 300,000 filers, the IRS will evaluate the benefits and burdens of adding a question explicitly about the for-profit history of an organization.

GAO’s recommendation on information collection seems to be informed by a concern that IRS “data matching techniques ... did not identify any of the existing tax-exempt organizations that purchased the seven for-profit colleges ... to select them for audit.” To be clear, the techniques described in the report were not intended to identify those purchasers of colleges. Instead, the data matching techniques were part of a compliance strategy on conversion to exempt status by organizations of all sorts. While this particular strategy is still in process, the results will inform future compliance efforts. Moreover, IRS has the capability to research various sectors as exemplified by reports on colleges and universities (2013) as well as hospitals (2009) posted on IRS.gov. On both the application and return, colleges file a separate schedule that identifies them as such, namely Form 1023, Schedule B, *Schools, Colleges & Universities*, and Form 990, Schedule E, *Schools*. Annually, we process thousands of internal and external referrals alleging malfeasance by specific organizations including colleges. IRS continually strives to improve the selection of cases for exam.

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**Appendix II: Comments from the Internal  
Revenue Service**

We share GAO's interest in ensuring compliance in this area and appreciate having the opportunity to review and comment on the draft report. Responses to your specific recommendations are enclosed. If you have any questions, please contact Margaret A. Von Lienen, Director, Exempt Organizations and Government Entities at 513-975-6562.

Sincerely,

**Sunita B. Lough** Digitally signed by Sunita B.  
Lough  
Date: 2020.11.06 13:45:43 -05'00'

Sunita Lough  
Deputy Commissioner for Services  
and Enforcement

Enclosure

Enclosure

**GAO Recommendations and IRS Responses to GAO Draft Report  
“Higher Education: IRS and Education Could Better Address Risks Associated  
with Some For-Profit College Conversions”**

**Recommendation 1:**

The Commissioner of IRS should assess the agency’s internal controls for reviewing for-profit college applications for tax-exempt status and improve the review process to ensure that staff appropriately apply agency guidance on assessing potentially improper benefit to insiders.

**Comment:** IRS will assess its internal controls, including its review process, for reviewing applications for tax-exempt status from organizations with a for-profit history and will make improvements to those controls including the review process, as appropriate.

**Recommendation 2:**

The Commissioner of IRS should collect information, for instance on the annual IRS filing tax-exempt organizations are required to submit, that would enable the agency to systematically identify tax-exempt colleges with a for-profit history for audit and other compliance activities.

**Comment:** Form 990 currently includes questions that allow for systematic identification of organizations that have undertaken transactions with insiders that may indicate an increased risk of inurement. Nevertheless, IRS will evaluate the benefits and burdens of collecting information about the for-profit history of an organization, including colleges.

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# Appendix III: Comments from the Department of Education

**Appendix III: Comments from the Department  
of Education**



October 30, 2020

Ms. Melissa Emrey-Arras  
Director, Education, Workforce, and Income Security Issues  
Government Accountability Office  
441 G Street, NW  
Washington, DC 20548

Dear Ms. Emrey-Arras:

Thank you for providing the U.S. Department of Education (Department) with the opportunity to respond to the draft Government Accountability Office (GAO) report, *IRS And Education Could Better Address Risks Associated with Some For-Profit College Conversions* (GAO-21-89).

The Department agrees with GAO that it is important to identify and respond to the risks that former owners or other insiders could improperly benefit from the conversion of a for-profit college to nonprofit status under Department regulations. In addition to responding to the recommendation in the draft GAO report, the Department would like to provide additional clarifications.

Specifically, GAO's reference to "59 final for-profit conversions from January 2011 through August 2020" (GAO draft report p. 3) and related references to "59 colleges" could potentially lead a reader of the draft report to conclude that the Department has evaluated and approved more nonprofit conversion transactions than it actually has reviewed. This concern was raised during the exit conference and subsequent correspondence with GAO. Additionally, it is the Department's understanding that when GAO uses the term "college," it is referring to a single postsecondary institution and all the institution's additional locations. The main campus of each college is identified by an OPE ID number, which is assigned by the Department. The college's additional locations are assigned sub-numbers. The Department considers a "school group" to be a group of colleges (i.e., each college consists of its main campus and any additional locations) under single ownership.

When a school group undergoes a change of ownership, several colleges may be sold, but it only involves one transaction. The Department reviewed fewer than 59 individual transactions, because several of the conversion transactions involved school groups that owned multiple colleges. On page 13 of the draft report GAO clarifies that "[t]he 59 colleges in our review were acquired by 20 separate tax-exempt organizations. In a few cases, the tax-exempt organization acquired more than one college—up to 20 colleges in one case." The Department requests that those numbers be clarified at the very beginning of the report, as well as that a distinction be made between "colleges" and groups of colleges involved in individual transactions. The potential for confusion continues in footnote 80 where GAO refers to "35 approved conversions"

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which again is a reference to individual OPE ID numbers, and not 35 transactions. The references to the number of “insider transactions” suffers from the same lack of clarity (unique transactions vs. number of OPE ID numbers in a single transaction).

As recognized in the GAO draft report, the Department’s review of nonprofit conversions has strengthened over time. Of the 20 separate conversion transactions, seven (comprising 30 of the 59 OPE ID numbers) were reviewed and approved by the Department before it began its heightened level of review of conversion transactions in 2016. Moreover, in a post-2016 review for a single transaction comprising 13 OPE ID numbers, the Department denied the approval for a change of ownership and conversion to nonprofit status for one of the OPE ID numbers, and eight of the 13 colleges (each with a separate OPE ID number) closed before a final decision was made. The four remaining OPE ID numbers are pending review in a second, separate transaction. Five of the 20 separate transactions (each with only a single OPE ID number) are also still under review by the Department.

In addition, two of the 20 transactions did not involve a change of ownership and conversion to nonprofit status. Rather, in each of these two transactions, an existing proprietary institution was acquired by, and became an additional location of, an established and approved nonprofit institution. As a result, the former proprietary college relinquished its individual OPE ID number when it became an additional location of the nonprofit college. Therefore, the requirements of 34 C.F.R. § 600.32 applied, instead of the requirements of 34 C.F.R. § 600.20 and 34 C.F.R. § 600.31.

The GAO draft report also includes a discussion of financial performance before and after change in ownership transactions based on whether insiders remained involved following the change of ownership. The Department conducts financial responsibility reviews at the highest level of ownership, and only one review is conducted per combined school group under single ownership. Accordingly, to the extent that “Figure 9: Financial Responsibility Composite Score of For-Profit Colleges Whose Conversion Involved Insiders, Year before and Year of Their Conversion Transactions” refers to “16 colleges,” financial statements for only nine entities were reviewed for nine separate school/school group transactions. Moreover, the Department understands the term “conversion” in the title of the graphics to refer to the closing of the change of ownership transaction itself – not the Department’s decision on the requested conversion to nonprofit status. Of the nine separate transactions involved, five of those transactions have been subject to the heightened level of review that the Department has conducted since 2016. Only one of those transactions was reviewed in the year following the change of ownership, and that request to convert to nonprofit status was denied. Of the remaining four transactions, the heightened reviews were conducted more than a year following the change of ownership. One of those four reviews resulted in an initial denial of the request to convert to nonprofit status. Following a significant restructuring of the financial terms of that transaction, the Department approved the request to convert to nonprofit status. The second of the four transactions reviewed more than a year following the change of ownership was approved only after significant restructuring of the financial terms of the transaction. The third and fourth transactions remain under review.

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“Figure 10: Financial Responsibility Composite Score of For-Profit Colleges whose Conversion Did Not Involve Insiders, Year before and Year of Their Conversion Transactions” refers to “36 of 40” colleges that changed ownership without insider involvement and had failing financial responsibility scores prior to the change in ownership. The Department notes that the 36 “failing” colleges involved only five separate school groups. Two of those five school group transactions (one involving 20 schools in the group) were reviewed prior to the Department’s heightened review. The third transaction (involving 13 schools in the group) resulted in the Department’s denial as to one school, the closure of several other schools in the group before the Department completed its post-closing review of the change of status, and the subsequent resale of the remaining schools in the group (and that subsequent second transaction is currently still under review). The fourth and fifth transactions were not ‘changes of ownership’; rather, they involved an acquisition of an additional location by an existing nonprofit institution. The four colleges with passing composite scores involved three separate school transactions. One of those transactions was reviewed and approved prior to 2016, and the other two were reviewed and approved after 2016.

The 33 colleges that were described as “nearing bankruptcy” involved two separate school group transactions. The “nearing bankruptcy” schools are also included in the “36 of 40” with failing composite scores in the year prior to the change of ownership. One transaction (the 20-school group referred to above) was reviewed and approved prior to 2016. The other school group transaction (the 13-school group) is described above (denial as to one school, closure of other schools in the group, and the subsequent sale of the remaining schools).

The GAO draft report also refers to “26 of 40” colleges without insider involvement that had passing financial composite scores in the year following the change of ownership. These schools involved six separate school/school group transactions. Three transactions were reviewed and approved prior to 2016 (including the 20-group transaction), and three were reviewed and approved after 2016 (one of which was the acquisition of an additional location by an existing nonprofit).

Our response to the one recommendation for the Department in the GAO draft report is set forth below.

**Recommendation 3:** The Secretary of Education should develop and implement monitoring procedures for staff to review the audited financial statements of all newly converted nonprofit colleges for the risk of improper benefit.

**Response:** The Department concurs with this recommendation. As such, the Department will develop modifications to existing decision letter templates to include additional reporting requirements for newly converted nonprofit colleges (e.g., reporting of any IRS issues impacting the nonprofit status of the institution or IRS actions with related parties that involve the conversion, any changes in status with the institution’s accrediting or state licensing agencies, and changes to existing service agreements, if any, between insiders and the institutions). Additionally, institutions will be required to report promptly any new or amended servicing or contracting agreements, and when another entity assumes any of responsibilities associated with the functional components of the institutions (in addition to the regulations requiring an

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**Appendix III: Comments from the Department  
of Education**

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institution to report changes related to third-party servicers). As appropriate, the decision letters may also direct the schools to provide additional financial reporting, including projected cash flow statements, which include information about their current operations and future plans, as well as enrollment monitoring reporting. Requirements for additional reporting will also be included as a condition in the provisional program participation agreement for Department review during the provisional period. The Department anticipates the need for closely monitoring newly converted nonprofit colleges for the risk of improper benefit until the school receives its first recertification after the change in ownership with nonprofit conversion.

The Department will develop new financial analysis procedures to ensure that all conversions are reviewed after the change in ownership by monitoring the additional reporting and subsequent financial statement submissions.

Thank you for the opportunity to respond to the recommendation outlined in this GAO draft report. We appreciate the time and the effort auditing this issue, as well as the opportunity to comment on the GAO draft report.

Sincerely,

*Mark A. Brown*

Mark A. Brown  
Chief Operating Officer  
Office of Federal Student Aid

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## Appendix IV: GAO Contact and Staff Acknowledgments

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### GAO Contact

Melissa Emrey-Arras at (617) 788-0534 or [emreyarrasm@gao.gov](mailto:emreyarrasm@gao.gov)

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### Staff Acknowledgments

In addition to the contact named above, Sharon Hermes (Assistant Director), Michelle St. Pierre (Assistant Director), Ellen Phelps Ranen (Analyst in Charge), Swati Deo, MacKenzie Cooper, Samuel Gaffigan, and Kristy Kennedy made key contributions to this report. Additional assistance was provided by James Bennett, William Beichner, Marcia L. Carlsen, Carrie Davidson, Lauren Gilbertson, Mark Glickman, Amber Gray, Risto Laboski, Sheila R. McCoy, Corinna Nicolaou, Sara Rizik, Monica Savoy, Thomas Short, Almeta Spencer, Lindsay Swenson, and Adam Wendel.

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## Appendix V: Accessible Data

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### Data Tables

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#### Accessible Data for Figure: Example of a For-Profit College Conversion with Officials in Insider Roles

- For-profit college officials...
- hold leadership roles in a nonprofit tax-exempt organization...
- that buys the for-profit college...
- converting it into a tax-exempt college

Source: GAO analysis of Internal Revenue Service (IRS) documents. | GAO-21-89

**Accessible Data for Figure 1: Example of a For-Profit College Reincorporating as a Nonprofit Organization and Applying for Tax Exempt Status**

- For-profit college reincorporates with the state as a nonprofit organization<sup>a</sup>...
- then applies to IRS for tax exemption...
- ...and becomes a tax-exempt college when approved<sup>b</sup>

Source: GAO analysis of Internal Revenue Service (IRS) documents. | GAO-21-89

**Accessible Data for Figure 2: Examples of a Nonprofit Organization with Tax-Exempt Status Purchasing a For-Profit College**

**Nonprofit college purchases a for-profit college**

- Tax-exempt, nonprofit college...
- buys a for-profit college...
- ...converting it into a tax-exempt college<sup>a</sup>

**Existing nonprofit organization purchases a for-profit college**

- *Existing* nonprofit organization with tax exemption...
- buys a for-profit college...
- ...converting it into a tax-exempt college<sup>a</sup>

**New nonprofit organization purchases a for-profit college**

- Individuals incorporate a *new* nonprofit organization with the state...
- that applies for and gains IRS tax exemption...
- then buy a for-profit college...
- ...converting it into a tax-exempt college<sup>a</sup>

Source: GAO analysis of Internal Revenue Service (IRS) documents. | GAO-21-89

**Accessible Data for Figure 3: Examples of How Insiders Can Initiate a For-Profit College Conversion**

- For-profit college officials...
- hold leadership roles in an existing nonprofit tax-exempt organization...
  - OR
- for-profit college officials create a new nonprofit that obtains IRS approval as a tax-exempt organization...
- ...that buys the for-profit college
- ...converting it into a tax-exempt college<sup>a</sup>

Source: GAO analysis of Internal Revenue Service (IRS) documents. | GAO-21-89

**Accessible Data for Figure 4: Conversion Methods for 59 For-Profit Colleges,  
January 2011 through August 2020**

Out of 59 total for-profit college conversions

<b>Category</b>	<b>Number of acquiring nonprofit organizations (20 total)</b>	<b>Number of for-profit colleges acquired (59 total)</b>
For-profit college reincorporated as a nonprofit organization	1	1
Purchased by an existing nonprofit college	5	5
Purchased by an existing nonprofit organization (not a college)	8	43
Purchased by a new nonprofit organization (not a college)	5	9
Donated to an existing nonprofit organization	1	1

Source: GAO analysis of Internal Revenue Service (IRS) documents. | GAO-21-89

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Appendix V: Accessible Data

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**Accessible Data for Figure 5: For-Profit College Conversions, by Year of Conversion Transaction, January 2011 through August 2020**

Year	Number of for-profit colleges included in each conversion transaction	Total number of for-profit colleges (59 total since 2011)	Number of nonprofit organizations (20 total)
2011	5; 1	6	2
2012	4	4	1
2013	1; 1; 1	3	3
2014	0	0	0
2015	20; 1; 1; 1; 1	24	5
2016	0	0	0
2017	13; 2; 1; 1; 1	18	5
2018	1; 1	2	2
2019	1; 1	2	2
2020	0	0	1

Source: GAO analysis of Department of Education documents. | GAO-21-89

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**Appendix V: Accessible Data**

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**Accessible Data for Figure 6: For-Profit College Conversions with and without Insider Involvement, January 2011 through August 2020**

<b>Category</b>	<b>Proportion details</b>
Insiders held leadership positions in the nonprofit organization that bought them <sup>a</sup>	17 (of 57 colleges)
Nonprofit buyers had no known connection to the college or its insiders	40 (of 57 colleges)

Source: GAO analysis of Internal Revenue Service (IRS) documents. | GAO-21-89

**Accessible Data for Figure 7: Hypothetical Example of How Insiders Could Improperly Benefit from a For-Profit College's Sale to a Nonprofit Organization**

- Insiders influence nonprofit purchaser to pay more for the college than it is worth
  - For example, college value is \$10 million, but college is sold for \$12 million
- Insiders improperly benefit from inflated sale price; college has fewer funds to support mission
  - In this example, inflated sale price is \$2 million

Source: GAO analysis of Internal Revenue Service (IRS) documents. | GAO-21-89

**Accessible Data for Figure 8: Hypothetical Example of How Insiders Could Improperly Benefit from Transactions with a Previously For-Profit College after its Sale to a Nonprofit Organization**

- Insiders rent facilities to tax-exempt college for above-market rate
  - For example, market rate is \$4 million, but college rents for \$5 million
- The inflated rental price improperly benefits the insiders; college has fewer funds to support mission
  - In this example, inflated sale price is \$1 million

Source: GAO analysis of Internal Revenue Service (IRS) documents. | GAO-21-89

**Accessible Data for Figure 9: Financial Responsibility Composite Scores of For-Profit Colleges Whose Conversion Transactions Involved Insiders, Year before and Year of Their Conversion Transactions**

**Number of for-profit colleges whose conversions involved insiders  
(16 total)**

<b>Category</b>	<b>Failing composite score</b>	<b>Passing composite score</b>
Year before sale	0	16
Year of sale	15	1

Source: GAO analysis of Department of Education (Education) data. | GAO-21-89

**Accessible Data for Figure 10: Financial Responsibility Composite Scores of For-Profit Colleges Whose Conversions Did Not Involve Insiders, Year before and Year of Their Conversion Transactions**

**Number of for-profit colleges whose conversions did not involve insiders (40 total)**

<b>Category</b>	<b>Failing composite score</b>	<b>Passing composite score</b>
Year before sale	36	4
Year of sale	14	26

Source: GAO analysis of Department of Education (Education) data. | GAO-21-89

**Accessible Data for Figure 11: Application Status of For-Profit Colleges That Completed Conversion Transactions between January 2011 and August 2020 and Applied to Education for Nonprofit College Status as of August 2020**

- 59 For-profit colleges sought nonprofit status from Education
  - 37 Colleges received a decision from Education
  - 22 Colleges do not have a decision from Education
    - 35 Colleges approved for nonprofit status by Education
    - 2 Colleges denied nonprofit by Education<sup>a</sup>
    - 9 Colleges have applications pending Education's decision<sup>b</sup>
    - 13 Colleges closed while waiting for a decision from Education

Source: GAO analysis of Department of Education documents. | GAO-21-89

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## Agency Comment Letters

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### Accessible Text for Appendix II Comments from the Internal Revenue Service

#### Page 1

November 6, 2020

Melissa Emrey-Arras  
Director, Education, Workforce, and Income Security Issues  
United States Government Accountability Office  
441 G Street, NW  
Washington, DC 20548

Dear Ms. Emrey-Arras:

Thank you for the opportunity to review the draft report of the Government Accountability Office entitled “Higher Education: IRS and Education Could Better Address Risks Associated with Some For-Profit College Conversions” GAO-21-89, (Job Code 103006). We appreciate your recognition that IRS collects information and maintains procedures to assess whether organizations attempting to convert to tax-exempt status comply with the applicable requirements of Internal Revenue Code (I.R.C.) section 501(c)(3). We share the goal of ensuring that applicants and staff appropriately apply these rules and procedures in every case.

GAO identifies 11 applications for recognition of tax-exempt status including the conversion of a for-profit college that involved “insiders” over the period from January 2011 through August 2020. During this period, IRS processed over 700,000 applications for recognition of I.R.C. section 501(c)(3) tax-exempt status. In two of the identified cases, GAO questions whether IRS sought “sufficient information to assess whether the nonprofit organization would pay insiders more than fair market value for the college.” As noted in the report, IRS complied with applicable procedures to make a determination in these cases based upon the “facts, attestations, and representations contained in the administrative record” under Section 3.05 of Rev. Proc. 2020-5, 2020-1 I.R.B. 241 (updated annually). IRS guidance also instructs staff to closely scrutinize

significant transactions between an applicant and its insiders to assure that they are consistent with fair market value, providing staff with the discretion to request an independent appraisal, where warranted. However, there is no requirement that specific information, such as an independent appraisal, be submitted during the determination process because every case rests on its own facts. In the two cases in question, the applications represented that an independent appraisal establishing a fair market value would be undertaken.

We believe our procedures were followed in the identified cases. Nonetheless, we appreciate GAO's study of this issue and constantly seek to improve our determinations process. We will continue to educate agents on the rules and procedures applicable to

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for-profit conversions involving "insiders", which, in particular, may raise questions as to whether the organization is complying with the requirement of Section 501(c)(3) that "no part of [its] net earnings ... inures to the benefit of any private shareholder or individual." In addition, our training will emphasize to agents their discretion to request additional information from applicants, such as an independent appraisal, when indicated by the particular facts of the application. To support our agents in this regard, IRS has provided determinations agents with 70 pages of selectable paragraphs with questions on topics as varied as functional integration to fundraising and has included questions about transactions with for-profit entities. We will continue to train agents on the proper use of this resource.

GAO also suggests that IRS collect information on the Form 990-series annual information return that would identify whether an organization has a for-profit history to "help IRS respond proactively to risks that some insiders could improperly use the resources of a tax-exempt college for their own personal benefit." We agree that there may be increased risk of inurement where an I.R.C. section 501(c)(3) organization, including but not limited to a tax-exempt college, engages in transactions with insiders. In fact, the Form 990 does ask whether the organization is a party to a business transaction (including a contract of sale) with certain interested parties, including current and former officers, directors, trustees, key employees, creators or founders, or substantial contributors. See Form 990, Part IV, line 28. Organizations answering yes then must provide additional information on Schedule L (Transactions with Interested Persons). The Form 990 also asks whether the organization owns a

disregarded entity or is related to any taxable or tax-exempt entity in Part IV, lines 33 and 34, in which case additional information on Schedule R (Related Organizations and Unrelated Partnerships) is required. These questions assist in identifying organizations engaged currently in transactions or relationships with insiders that may indicate increased risk of inurement in the year for which the return is filed. In view of the entire population of 300,000 filers, the IRS will evaluate the benefits and burdens of adding a question explicitly about the for-profit history of an organization.

GAO's recommendation on information collection seems to be informed by a concern that IRS "data matching techniques ... did not identify any of the existing tax-exempt organizations that purchased the seven for-profit colleges ... to select them for audit." To be clear, the techniques described in the report were not intended to identify those purchasers of colleges. Instead, the data matching techniques were part of a compliance strategy on conversion to exempt status by organizations of all sorts. While this particular strategy is still in process, the results will inform future compliance efforts. Moreover, IRS has the capability to research various sectors as exemplified by reports on colleges and universities (2013) as well as hospitals (2009) posted on IRS.gov. On both the application and return, colleges file a separate schedule that identifies them as such, namely Form 1023, Schedule B, Schools, Colleges & Universities, and Form 990, Schedule E, Schools. Annually, we process thousands of internal and external referrals alleging malfeasance by specific organizations including colleges. IRS continually strives to improve the selection of cases for exam.

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We share GAO's interest in ensuring compliance in this area and appreciate having the opportunity to review and comment on the draft report. Responses to your specific recommendations are enclosed. If you have any questions, please contact Margaret A. Von Lienen, Director, Exempt Organizations and Government Entities at 513-975-6562.

Sincerely,

Sunita Lough  
Deputy Commissioner for Services  
and Enforcement Enclosure

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Recommendation 1:

The Commissioner of IRS should assess the agency's internal controls for reviewing for-profit college applications for tax-exempt status and improve the review process to ensure that staff appropriately apply agency guidance on assessing potentially improper benefit to insiders.

Comment: IRS will assess its internal controls, including its review process, for reviewing applications for tax-exempt status from organizations with a for-profit history and will make improvements to those controls including the review process, as appropriate.

Recommendation 2:

The Commissioner of IRS should collect information, for instance on the annual IRS filing tax-exempt organizations are required to submit, that would enable the agency to systematically identify tax-exempt colleges with a for-profit history for audit and other compliance activities.

Comment: Form 990 currently includes questions that allow for systematic identification of organizations that have undertaken transactions with insiders that may indicate an increased risk of inurement. Nevertheless, IRS will evaluate the benefits and burdens of collecting information about the for-profit history of an organization, including colleges.

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## Accessible Text for Appendix III Comments from the Department of Education

### Page 1

October 30, 2020

Ms. Melissa Emrey-Arras  
Director, Education, Workforce, and Income Security Issues  
Government Accountability Office  
441 G Street, NW  
Washington, DC 20548

Dear Ms. Emrey-Arras:

Thank you for providing the U.S. Department of Education (Department) with the opportunity to respond to the draft Government Accountability Office (GAO) report, *IRS And Education Could Better Address Risks Associated with Some For-Profit College Conversions* (GAO-21-89).

The Department agrees with GAO that it is important to identify and respond to the risks that former owners or other insiders could improperly benefit from the conversion of a for-profit college to nonprofit status under Department regulations. In addition to responding to the recommendation in the draft GAO report, the Department would like to provide additional clarifications.

Specifically, GAO's reference to "59 final for-profit conversions from January 2011 through August 2020" (GAO draft report p. 3) and related references to "59 colleges" could potentially lead a reader of the draft report to conclude that the Department has evaluated and approved more nonprofit conversion transactions than it actually has reviewed. This concern was raised during the exit conference and subsequent correspondence with GAO. Additionally, it is the Department's understanding that when GAO uses the term "college," it is referring to a single postsecondary institution and all the institution's additional locations. The main campus of each college is identified by an OPE ID number, which is assigned by the Department. The college's additional locations are assigned sub-numbers. The Department considers a

“school group” to be a group of colleges (i.e., each college consists of its main campus and any additional locations) under single ownership.

When a school group undergoes a change of ownership, several colleges may be sold, but it only involves one transaction. The Department reviewed fewer than 59 individual transactions, because several of the conversion transactions involved school groups that owned multiple colleges. On page 13 of the draft report GAO clarifies that “[t]he 59 colleges in our review were acquired by 20 separate tax-exempt organizations. In a few cases, the tax-exempt organization acquired more than one college—up to 20 colleges in one case.” The Department requests that those numbers be clarified at the very beginning of the report, as well as that a distinction be made between “colleges” and groups of colleges involved in individual transactions. The potential for confusion continues in footnote 80 where GAO refers to “35 approved conversions”

## Page 2

which again is a reference to individual OPE ID numbers, and not 35 transactions. The references to the number of “insider transactions” suffers from the same lack of clarity (unique transactions vs. number of OPE ID numbers in a single transaction).

As recognized in the GAO draft report, the Department’s review of nonprofit conversions has strengthened over time. Of the 20 separate conversion transactions, seven (comprising 30 of the 59 OPE ID numbers) were reviewed and approved by the Department before it began its heightened level of review of conversion transactions in 2016. Moreover, in a post-2016 review for a single transaction comprising 13 OPE ID numbers, the Department denied the approval for a change of ownership and conversion to nonprofit status for one of the OPE ID numbers, and eight of the 13 colleges (each with a separate OPE ID number) closed before a final decision was made. The four remaining OPE ID numbers are pending review in a second, separate transaction. Five of the 20 separate transactions (each with only a single OPE ID number) are also still under review by the Department.

In addition, two of the 20 transactions did not involve a change of ownership and conversion to nonprofit status. Rather, in each of these two transactions, an existing proprietary institution was acquired by, and became an additional location of, an established and approved nonprofit institution. As a result, the former proprietary college relinquished its

individual OPE ID number when it became an additional location of the nonprofit college. Therefore, the requirements of 34 C.F.R. § 600.32 applied, instead of the requirements of 34 C.F.R. § 600.20 and 34 C.F.R. § 600.31.

The GAO draft report also includes a discussion of financial performance before and after change in ownership transactions based on whether insiders remained involved following the change of ownership. The Department conducts financial responsibility reviews at the highest level of ownership, and only one review is conducted per combined school group under single ownership. Accordingly, to the extent that “Figure 9: Financial Responsibility Composite Score of For-Profit Colleges Whose Conversion Involved Insiders, Year before and Year of Their Conversion Transactions” refers to “16 colleges,” financial statements for only nine entities were reviewed for nine separate school/school group transactions. Moreover, the Department understands the term “conversion” in the title of the graphics to refer to the closing of the change of ownership transaction itself – not the Department’s decision on the requested conversion to nonprofit status. Of the nine separate transactions involved, five of those transactions have been subject to the heightened level of review that the Department has conducted since 2016. Only one of those transactions was reviewed in the year following the change of ownership, and that request to convert to nonprofit status was denied. Of the remaining four transactions, the heightened reviews were conducted more than a year following the change of ownership. One of those four reviews resulted in an initial denial of the request to convert to nonprofit status. Following a significant restructuring of the financial terms of that transaction, the Department approved the request to convert to nonprofit status. The second of the four transactions reviewed more than a year following the change of ownership was approved only after significant restructuring of the financial terms of the transaction. The third and fourth transactions remain under review.

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“Figure 10: Financial Responsibility Composite Score of For-Profit Colleges whose Conversion Did Not Involve Insiders, Year before and Year of Their Conversion Transactions” refers to “36 of 40” colleges that changed ownership without insider involvement and had failing financial responsibility scores prior to the change in ownership. The Department notes that the 36 “failing” colleges involved only five separate school groups. Two of those five school group transactions (one involving 20 schools in the group) were reviewed prior to the Department’s heightened

review. The third transaction (involving 13 schools in the group) resulted in the Department's denial as to one school, the closure of several other schools in the group before the Department completed its post-closing review of the change of status, and the subsequent resale of the remaining schools in the group (and that subsequent second transaction is currently still under review). The fourth and fifth transactions were not 'changes of ownership'; rather, they involved an acquisition of an additional location by an existing nonprofit institution. The four colleges with passing composite scores involved three separate school transactions. One of those transactions was reviewed and approved prior to 2016, and the other two were reviewed and approved after 2016.

The 33 colleges that were described as "nearing bankruptcy" involved two separate school group transactions. The "nearing bankruptcy" schools are also included in the "36 of 40" with failing composite scores in the year prior to the change of ownership. One transaction (the 20-school group referred to above) was reviewed and approved prior to 2016. The other school group transaction (the 13-school group) is described above (denial as to one school, closure of other schools in the group, and the subsequent sale of the remaining schools).

The GAO draft report also refers to "26 of 40" colleges without insider involvement that had passing financial composite scores in the year following the change of ownership. These schools involved six separate school/school group transactions. Three transactions were reviewed and approved prior to 2016 (including the 20-group transaction), and three were reviewed and approved after 2016 (one of which was the acquisition of an additional location by an existing nonprofit).

Our response to the one recommendation for the Department in the GAO draft report is set forth below.

**Recommendation 3:** The Secretary of Education should develop and implement monitoring procedures for staff to review the audited financial statements of all newly converted nonprofit colleges for the risk of improper benefit.

**Response:** The Department concurs with this recommendation. As such, the Department will develop modifications to existing decision letter templates to include additional reporting requirements for newly converted nonprofit colleges (e.g., reporting of any IRS issues impacting the nonprofit status of the institution or IRS actions with related parties that involve the conversion, any changes in status with the institution's

accrediting or state licensing agencies, and changes to existing service agreements, if any, between insiders and the institutions). Additionally, institutions will be required to report promptly any new or amended servicing or contracting agreements, and when another entity assumes any of responsibilities associated with the functional components of the institutions (in addition to the regulations requiring an

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institution to report changes related to third-party servicers). As appropriate, the decision letters may also direct the schools to provide additional financial reporting, including projected cash flow statements, which include information about their current operations and future plans, as well as enrollment monitoring reporting. Requirements for additional reporting will also be included as a condition in the provisional program participation agreement for Department review during the provisional period. The Department anticipates the need for closely monitoring newly converted nonprofit colleges for the risk of improper benefit until the school receives its first recertification after the change in ownership with nonprofit conversion.

The Department will develop new financial analysis procedures to ensure that all conversions are reviewed after the change in ownership by monitoring the additional reporting and subsequent financial statement submissions.

Thank you for the opportunity to respond to the recommendation outlined in this GAO draft report. We appreciate the time and the effort auditing this issue, as well as the opportunity to comment on the GAO draft report.

Sincerely,

Mark A. Brown  
Chief Operating Officer  
Office of Federal Student Aid

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