



Testimony
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HIGHER EDUCATION

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

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Chairman Scott, Republican Leader Foxx, and Members of the Committee:

I am pleased to be here today to discuss for-profit college conversions. 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). A for-profit college may seek to become a tax-exempt nonprofit college for a variety of reasons. For example, it may wish to better align its status with its mission or obtain access to certain federal or state grants. A for-profit college may also wish to obtain perceived reputational benefits of nonprofit college status. In some cases, a for-profit college may seek to reduce its tax burden or avoid federal student aid limits applicable to for-profit colleges.¹

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 a leadership role in the newly nonprofit college. IRS guidance refers to such individuals with influence over a nonprofit organization, like a college, as insiders.² The ongoing involvement of insiders familiar with a college's history and operations can promote continuity and stability. However, there is also a risk that insiders may use their influence to improperly benefit themselves financially at the expense of the college's nonprofit mission—for instance, by steering college contracts toward businesses the insiders control for an inflated price. Doing so would be impermissible under the Internal

¹We define federal student aid programs as financial aid programs authorized under Title IV of the Higher Education Act of 1965, as amended (Higher Education Act). These include the William D. Ford Federal Direct Loan, the Federal Pell Grant, and the Federal Work-Study programs.

²According 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.

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.³

My testimony today is based on our December 2020 report on for-profit college conversions.⁴ My statement addresses (1) what is known about insider involvement in for-profit college conversions, (2) 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, and (3) 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 successfully obtain, nonprofit status in federal student aid programs.⁵ I will also highlight three actions we recommended to improve agency oversight of conversions—two to IRS and one to Education. Our December 2020 report relied on multiple methodologies which are described in more detail in that report, along with our assessment of data reliability. For this testimony, we also requested updates from IRS and Education officials on the progress of the agencies in implementing our recommendations from the 2020 report, along with an update of Education’s ongoing actions to provide advertising instructions to colleges.

The work upon which this statement is based was conducted 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.

³See 20 U.S.C. § 1003(13) and 26 U.S.C. § 501(c)(3).

⁴See GAO, *Higher Education: IRS and Education Could Better Address Risks Associated with Some For-Profit College Conversions*, [GAO-21-89](#) (Washington, D.C.: Dec. 31, 2020).

⁵We 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 the 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).

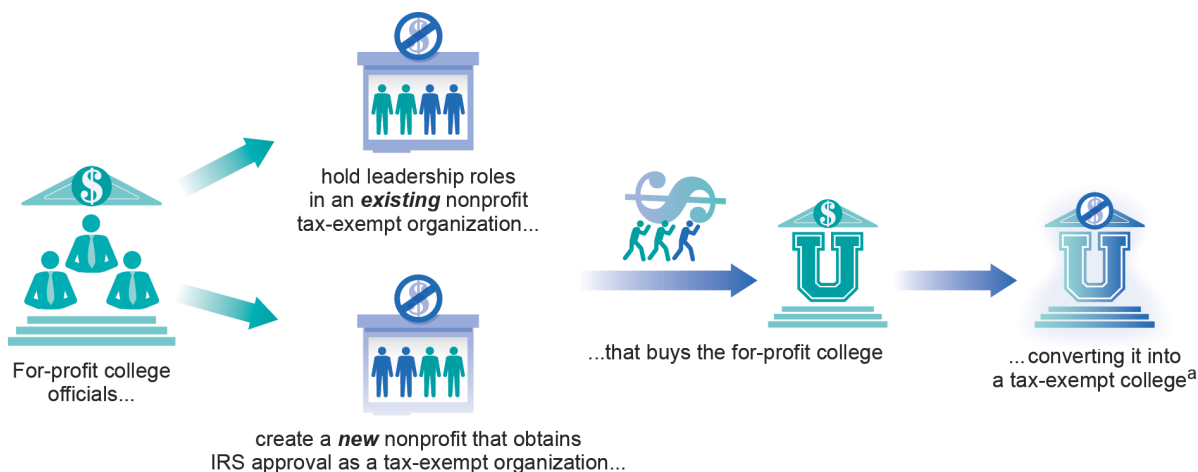
Background

To obtain nonprofit college status, a for-profit college must first be recognized as tax-exempt by IRS and then obtain Education approval to participate in federal student aid programs as a nonprofit college.⁶

IRS Tax-Exempt Status and Monitoring

A for-profit college may obtain IRS tax-exempt status in a variety of ways. For example, a for-profit college may apply to IRS directly for tax-exempt status after reincorporating as a nonprofit organization at the state level. In other cases, a for-profit college may obtain tax-exempt status after its sale to a new nonprofit organization created to purchase the college or an existing nonprofit organization that has already been approved by IRS as tax-exempt. Owners or executives of the for-profit college may already have a relationship with the nonprofit organization and be involved in initiating the conversion (see figure 1).

Figure 1: Examples of How Insiders Can Initiate a For-Profit College Conversion



Source: GAO analysis of Internal Revenue Service (IRS) documents. | GAO-21-500T

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 hold 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

⁶We 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.

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).

⁸Education has additional processes for approving a for-profit college to become a nonprofit college for federal student aid purposes.

When applying to IRS for tax-exempt status, a nonprofit organization provides information that IRS uses to assess whether the organization is organized and operated exclusively for tax-exempt purposes and to ensure that no part of the applicant's net earnings improperly benefit insiders, such as the organization's founders.⁷ Improper benefit is impermissible and is grounds for denial or revocation of tax-exempt status under the Internal Revenue Code (see text box).⁸

Improper Benefit

Inurement, which GAO refers to in this statement 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-21-500T

IRS generally relies on information provided by the applicant to determine if the requirements of tax-exempt status are met. However, IRS staff members may ask questions or request documentation to help them assess whether the organization meets the requirements of tax-exempt status.

After IRS has approved an organization for tax-exempt status, the organization is generally required to submit annual filings with information on their activities and finances.⁹ IRS selects tax-exempt organizations for

⁷Colleges 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.

⁸Tax-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). Insiders may include a tax-exempt organization's founders, members of its board, their families, and others. 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).

⁹If an existing tax-exempt organization purchases a for-profit college, it would describe its new activities, such as operating a college, on its next annual IRS filing.

audit based on indicators of potential noncompliance contained in these annual filings.¹⁰ In some cases, IRS initiates audits as a part of special projects called compliance strategies, which focus on specific areas of tax noncompliance, such as improper benefit to insiders. If IRS finds tax noncompliance through an audit, it can impose penalties on an organization, and may revoke tax-exempt status if it finds that the organization improperly benefits insiders.

Education Nonprofit College Status and Monitoring

After a for-profit college has obtained tax-exempt status, it must separately obtain approval from Education to participate in federal student aid programs as a nonprofit college.¹¹ To be recognized by Education as a nonprofit college, a 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.¹²

Education evaluates an application for nonprofit college status submitted by a for-profit college, or a group of colleges with the same owner, that has undergone a conversion transaction. These applications contain information including (1) proof of accreditor, state, and IRS approval; (2) two years of audited financial statements; and (3) a copy of the college or college group's balance sheet as of the day it changed owners. Once Education approves a for-profit college's application for nonprofit college status, the college is required to participate in federal student aid programs under provisional approval for at least 1 to 3 years. Colleges that are provisionally approved are subject to additional requirements—

¹⁰Technically, IRS selects an annual filing submitted by tax-exempt organizations for examination. In this statement, we refer to this IRS process as an audit.

¹¹Until 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.

¹²See 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).

for instance, they may be temporarily prohibited from adding new programs or opening new locations—and are monitored by Education to ensure they comply with the specified provisional conditions.

Education also has ongoing monitoring activities applicable to all colleges, such as periodic recertification of all colleges' eligibility to participate in federal student aid programs and more in-depth program reviews to assure that selected colleges are complying with key federal student aid requirements. In addition, Education annually reviews the audited financial statements of all colleges as part of its process to assess their financial health. Education can impose sanctions and corrective actions on colleges that violate program rules.

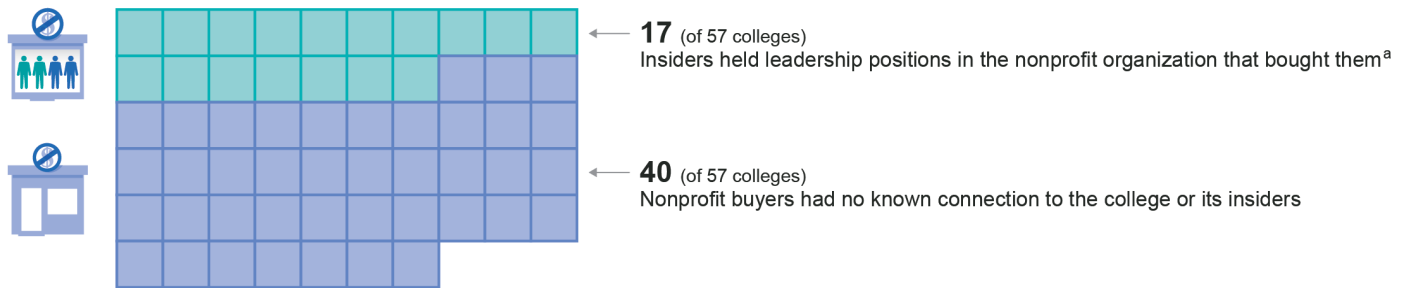
Some For-Profit College Conversions Involved Insiders, Which May Pose Risk of Improper Benefit

In our December 2020 report, we identified 59 for-profit colleges that underwent conversion transactions from January 2011 through August 2020. 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 tax-exempt purchaser, holding nonprofit leadership roles before or upon conclusion of the conversion transaction.¹³ By contrast, the other two-thirds of colleges in our review (40 of 57) were sold to unrelated nonprofit organizations (see figure 2). Collectively, colleges whose conversions involved insiders received nearly \$1.8 billion in federal student aid funds in the 2018-2019 award year.¹⁴

¹³We 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.

¹⁴Of 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.

Figure 2: For-Profit College Conversions with and without Insider Involvement, January 2011 through August 2020



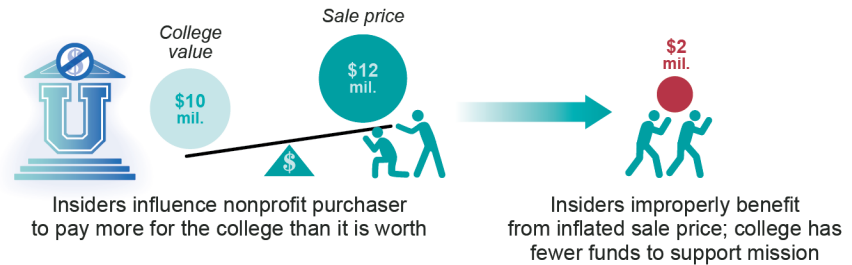
Source: GAO analysis of Internal Revenue Service (IRS) documents. | GAO-21-500T

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 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), 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.

^aIn 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.

Insider involvement in a conversion may have benefits for a college, such as enhancing operational stability; however, it also poses a risk that the college’s earnings could be used to improperly benefit insiders rather than the college’s nonprofit mission. For instance, if a nonprofit organization’s board does not exercise due diligence when it purchases a for-profit college from insiders, those insiders could influence the board to purchase the college for more than it is worth. As a result, the insiders would improperly benefit from the inflated price (see figure 3). Similarly, former for-profit college owners who continue to lead a newly tax-exempt college after selling it could influence that college to rent facilities from companies they own for an over-market rates resulting in improper benefit to the former owners.

Figure 3: Hypothetical Example of How Insiders Could Improperly Benefit from a For-Profit College Conversion



Source: GAO analysis of Internal Revenue Service (IRS) documents. | GAO-21-500T

Note: 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 financial interests of insiders over those of the nonprofit organization.

Roles of insiders in five case study colleges: In our December 2020 report, we described five case study colleges whose conversions involved insiders for more in-depth review.¹⁵ In four of five cases, insiders led the college's nonprofit purchaser (e.g., as founder or board chair) before the conversion transaction. In all five cases, former owners or shareholders continued to serve as the college's president or chief executive officer after the sale.¹⁶ In addition, because each conversion transaction was seller-financed, all five newly tax-exempt colleges made loan payments to the for-profit seller while an individual with an ownership stake in the for-profit seller continued to lead the college. In two of five cases, former owners also acted as landlord to colleges, leasing back properties that were not included in the original sale. Further, in three of five cases, former owners acted as vendors to the tax-exempt college. One college president owned companies that provided a wide variety of services to the tax-exempt college. In another case, the college president was also

¹⁵The five colleges selected for case studies are not representative of all for-profit college conversions with insider involvement, but rather serve as illustrative examples. Because our review focused on IRS and Education oversight, we did not conduct an audit of any college to determine whether its conversion improperly benefitted insiders.

¹⁶Insiders also assumed roles on the board of the newly tax-exempt college in three of five cases.

the chief executive of the college's former corporate owner and an extensive service provider.

As discussed in our December 2020 report, officials from our five case study colleges described positive goals for their conversion, such as enhancing the student experience (four of five cases), aligning the college's status with its character or mission (three of five cases), and bolstering college resources by enabling it to accept charitable contributions (two of five cases). They also described benefits from the ongoing leadership of officials familiar with the college.

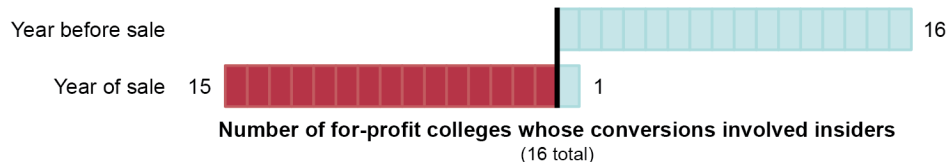
Officials from all five case study colleges also reported safeguards that could mitigate the risk of improper benefit. In particular, officials from all five colleges said they used professional opinions from independent experts (e.g., financial valuation firms or appraisers) when negotiating their conversion transaction and utilized conflict of interest policies. Officials from four of five colleges also described taking steps over time to end or reduce certain financial ties with former owners. For instance, officials from two of five colleges noted that they later refinanced the loans they owed to former owners with unrelated parties.

Financial performance based on Education measures: Using Education financial measures, we reported that colleges converting with insiders involved generally had stronger performance before their conversion, but weaker performance in the year of 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 also had a passing financial responsibility composite score—which Education calculates annually to assess a college's financial health—in the year before its sale.¹⁷ However, almost

¹⁷The 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. 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.

all of these colleges whose conversions involved insiders (15 of 16) had a failing composite score in the year of its sale (see figure 4).¹⁸

Figure 4: Financial Responsibility Composite Scores of For-Profit Colleges Whose Conversion Transaction Involved Insiders, Year before and Year of the Transaction
 Failing composite score ◀ ▶ Passing composite score



Source: GAO analysis of Department of Education (Education) data. | GAO-21-500T

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.

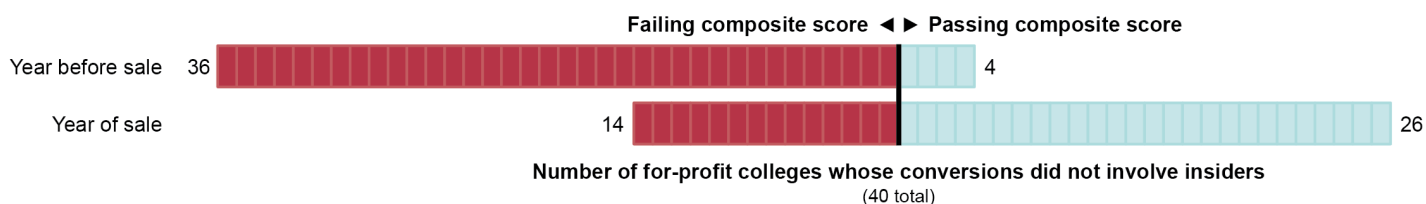
Insiders are defined as persons with a personal and private interest in a tax-exempt organization’s activities who, by virtue of a special relationship with the organization, are able to influence its financial decisions. GAO considered for-profit college officials to be insiders in a conversion if (1) 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.

¹⁸Education 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.

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.¹⁹ After their sales, most of these colleges (26 of 40) had passing financial responsibility composite scores (see figure 5).²⁰

Figure 5: 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-21-500T

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.

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¹⁹The 33 colleges nearing bankruptcy were part of two separate conversion transactions involving groups of for-profit colleges sold to two different nonprofit purchasers.

²⁰The 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.

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 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 purchased college's financial health.

While assessing the current financial condition of all converted colleges was not within the scope of our review, in December 2020 we noted that a college's financial condition may also change over time. A college whose financial condition improves after its sale may find that improvement short-lived, for instance, if its new owners lack the expertise needed to successfully operate a college. Conversely, a college whose financial condition declines after its sale may ultimately experience improved financial circumstances if its ability to attract and retain students improves and the college pays down debt associated with its change in ownership.²¹

IRS Did Not Consistently Identify and Respond to Risks That Insiders May Improperly Benefit from Previously For-Profit Colleges

²¹ Four of our five case study colleges had failing composite scores in the year of their conversion transaction; in two cases, the colleges' composite scores improved to passing 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, which had a positive effect on both colleges' composite scores.

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

In our December 2020 report, 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 conversions. Improper benefit is grounds to deny an application for tax-exempt status and IRS staff training materials instruct staff to carefully scrutinize applications that disclose a for-profit conversion transaction to determine whether it will be consistent with fair market value or improperly benefit insiders.²² However, we found that in two cases IRS approved applications for tax-exempt status that disclosed plans to purchase a for-profit college from insiders without IRS knowing the college's planned sale price.²³ Further, IRS staff did not request other information—such as an independent appraisal report estimating the college's value—that could help IRS staff assess whether the applicant would meet tax-exempt requirements.

In both cases, the organizations applying for tax-exempt status were created by insiders expressly to purchase a for-profit college. However, instead of disclosing the college's planned sale price or copies of independent appraisal reports, both applications stated that independent appraisals would be conducted in the future and that the sale prices, once determined, would not exceed fair market value. Both applications also disclosed plans to purchase extensive contractual services from the colleges' former for-profit owners. 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.²⁴

²²According to Department of the 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. 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.

²³Altogether, 11 planned conversions involving insiders were disclosed in an application for tax-exempt status, including 10 of the 17 for-profit college conversions involving insiders in our review and an additional planned for-profit college conversion that ultimately did not occur.

²⁴IRS training materials state that staff should carefully assess whether the contracts exceed the fair market value of the services being provided.

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.²⁵ 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.

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.²⁶ At the time of our study, however, IRS officials stated that they had not assessed whether the agency's internal controls were 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. In response, we recommended that the Commissioner of Internal Revenue assess these internal controls and improve the review process to ensure that staff appropriately apply agency guidance on assessing potential improper benefit to insiders. As of March 2021, IRS officials said that they were in the process of assessing the agency's internal controls for reviewing for-profit college applications for tax-exempt status and would make any improvements to its controls and processes as appropriate based on the review.

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

Although IRS conducts audits of tax-exempt organizations at risk of noncompliance with federal tax law, we found in our December 202 report that it did not collect the information it needs to systematically identify colleges or other organizations with a for-profit history for potential audit. In our December 2020 report, seven of the 17 for-profit college conversions in our review that involved insiders were not disclosed in an application for tax-exempt status because the college's purchaser was already tax-exempt. As a result, IRS did not have the opportunity to review these conversions as a part of its decision to grant the purchaser

²⁵Officials 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.

²⁶GAO, *Standards for Internal Control in the Federal Government*, [GAO-14-704G](#) (Washington, D.C.: September 2014).

tax-exempt status. Instead, an audit would be IRS's first opportunity to assess whether these conversions involving an existing tax-exempt organization were consistent with the requirements of tax-exempt status.

However, as we described in our December 2020 report, the annual filing IRS uses to select tax-exempt organizations for audit does not have a data field that asks whether the organization has purchased a for-profit entity or otherwise has a for-profit history. The lack of information in an easily searchable data field means that IRS cannot systematically select for audit tax-exempt organizations whose annual filings disclose purchasing a for-profit college from insiders. This lack of information hampered IRS's oversight efforts when IRS implemented a compliance strategy whose goal was to identify tax-exempt colleges and other organizations that have been part of a for-profit conversion, due to their heightened risk of improper benefit.²⁷ Because IRS had 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.

IRS could require tax-exempt organizations to report the purchase of a for-profit college or other for-profit entity in a searchable data field on their annual IRS filing, but it has not done so. IRS officials stated that doing so was unnecessary since the agency's application form for tax-exempt 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. Standards for internal control in the federal government state that agencies should use quality information to make decisions.²⁸ We therefore recommended that the Commissioner of Internal Revenue collect information that would enable the agency to systematically identify tax-exempt colleges with a for-profit history for audit and other compliance activities. As of March 2021, IRS officials reported that they planned to evaluate the benefits and burdens of collecting additional information about the for-profit history of tax-exempt organizations, including colleges. We continue to believe that collecting such information would better position IRS to systematically

²⁷The 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.

²⁸[GAO-14-704G](#)

identify organizations with a for-profit history, which the agency acknowledges pose a heightened risk of improper benefit.

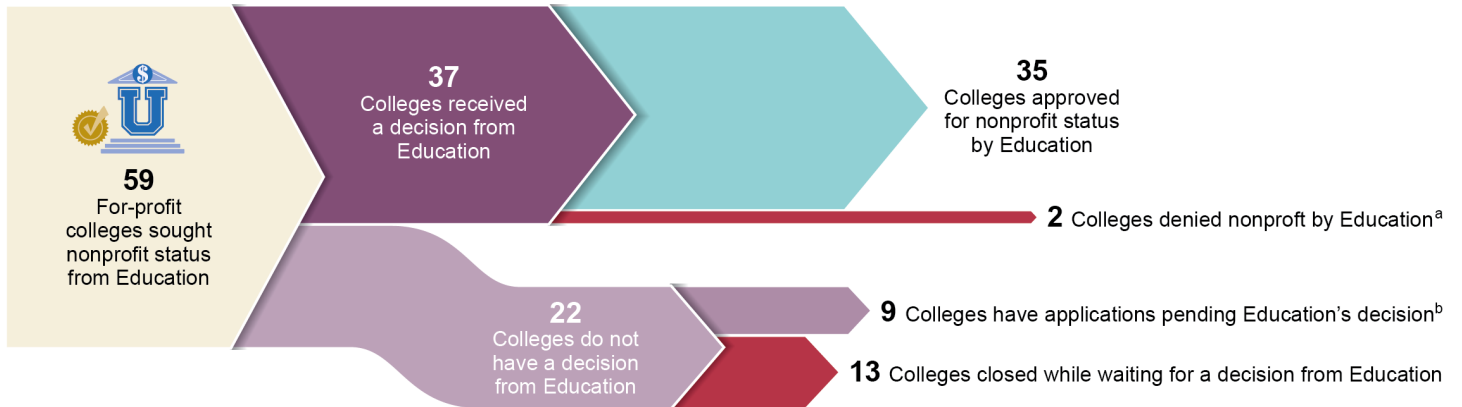
While Education Began Reviewing Nonprofit Applications More Closely, It Did Not Take Steps to Assess the Risk of Improper Benefit among Newly Converted Colleges

Education Enhanced Its Reviews of For-Profit College Applications for Nonprofit Status and Developed Advertising Instructions

As we reported in December 2020, Education had enhanced its process for reviewing applications from for-profit colleges seeking to convert to nonprofit college status in recent years. From November 2010 through August 2020, 59 for-profit colleges, which were part of 20 separate conversion transactions, applied to Education for nonprofit college status.²⁹ As of August 2020, Education had approved 35 of these 59 colleges for nonprofit status and denied two. The remaining applications were under review or no longer required action because the colleges had closed (see figure 6).

²⁹These 59 colleges were acquired by 20 separate tax-exempt organizations. A few tax-exempt organizations acquired more than one college—up to 20 colleges in one case. In one case, the for-profit college itself reincorporated as a nonprofit organization (rather than being purchased by a separate nonprofit organization).

Figure 6: 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-21-500T

Notes: 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.

^aIn 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.

^bThese colleges continue to participate in federal student aid programs as for-profit colleges.

In our review, 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, such as nonprofit conversions. In our review of three case study colleges that Education approved for nonprofit college status, we found that agency staff did not identify or follow up on potential risks of improper benefit in either of the case study colleges whose conversions Education approved prior to 2016.³⁰ However, Education began developing a more robust review process in 2016 and the agency started requesting copies of documents—such as names of board members, purchase and sale agreements, and appraisal

³⁰Because 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.

reports—to assess risk of improper benefit to insiders, according to agency officials. Education reviewed the application for one of our case study colleges after 2016 and obtained additional information, such as lease and debt terms, which agency officials said they used to assess whether the former owners were benefitting improperly from those agreements.

Education took additional steps to improve its processes in September 2018 when it created a centralized team composed of Education staff with contract review, finance, and legal expertise to help staff review for-profit college applications for nonprofit college status and identify risks of improper benefit, according to agency officials. This team was involved in a recent Education determination regarding a for-profit college's application for nonprofit college status, which 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.³¹ As a result of these and other actions, we found that Education was better positioned moving forward to thoroughly evaluate for-profit college applications for nonprofit status and mitigate the risk of improper benefit.

Our December 2020 report also found that for-profit colleges advertised as nonprofit colleges while Education was reviewing their applications. Specifically, the nine colleges with pending applications for nonprofit college status at the time of our review had all advertised as nonprofit colleges. 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.³² One college issued a press release the day after it obtained tax-exempt status from IRS—and three years before Education approved its application—stating that it was now a nonprofit tax-exempt educational institution whose conversion had been

³¹While 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.

³²For 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.

conducted in accordance with “the requirements of the U.S. Department of Education.”

As we noted in our report, some experts on student college choice suggested 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 such a 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 base their educational decisions.

Education officials acknowledged concerns about unclear language in colleges’ advertisements while their applications are under review.³³ At the time of our review, Education had recently developed instructions to prohibit for-profit colleges with pending applications from advertising as nonprofit colleges and officials said that they planned to provide these instructions to all for-profit colleges that apply for nonprofit college status. As of March 2021, Education officials told us that they had provided these instructions to five of the nine colleges with pending applications, and planned to provide the instructions to an additional college as part of a document request in the near future. According to Education officials, of the three remaining colleges, one had closed and the other two have pending decision letters that will be issued in the near future and will contain advertising instructions, as appropriate. Providing these advertising instructions to colleges should help Education curtail this type of potentially confusing advertising and help ensure that students have clear and accurate information upon which to base their educational decisions.

³³Education officials noted that the agency cannot restrict colleges from referring to their tax-exempt status conferred by the IRS. 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.

After Approving Conversions, Education Did Not Review College Financial Statements to Identify Potential Risk Indicators for Improper Benefit among Converted Nonprofit Colleges

As we reported in December of 2020, 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 did not use its existing reviews of college financial statements to assess this risk.³⁴ Colleges are required to disclose information in their audited financial statements that can provide Education with important insights into possible improper benefit. For instance, in accordance with accounting standards, colleges must disclose related-party transactions, such as leases or contracts with insiders, as well as related-party debt. However, when Education staff reviewed a previously for-profit college's audited financial statements, they did not assess whether the statements contain indicators of potential improper benefit—even if the college is newly converted and participating in federal student aid programs under provisional authorization, a time during which they should be monitored more closely.³⁵

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. 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. This college's financial statements also showed that the college, whose purchase price consisted almost exclusively of intangible assets (such as goodwill, accreditation, and established student relationships), recognized a substantial loss on those assets just a few years later.³⁶ While a substantial loss on intangible assets 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

³⁴The 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.

³⁵According 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.

³⁶Intangible assets are inherently difficult to value. In general, purchasers pay the current perceived value of owning intangible assets, taking into account expectations about future performance.

benefit insiders.³⁷ 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). However, staff also said that they had not considered whether the loss reflected a risk of improper benefit.

At the time of our report, Education had not developed plans to assess the financial statements of newly converted nonprofit colleges for indicators of possible improper benefit, even though we found they may contain new and relevant information about potential risks. Education officials stated that it would be reasonable for the agency to do so as a part of its annual audited financial statement review process. Officials further said that they could develop relevant procedures to ensure that such a review occurs and that identified concerns are provided to Education's centralized review team for further evaluation.

Without procedures in place for reviewing audited financial statements to look for indicators of improper benefit at newly converted nonprofit colleges, we found that Education lacked reasonable assurance that federal student aid funds are used appropriately and do not improperly benefit insiders. Standards for internal control in the federal government state that agency management should design control activities to achieve objectives and respond to risks.³⁸ As a result, we recommended that the Secretary of Education 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. In its written comments, Education agreed with the recommendation and 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.

As of March 2021, Education reported that it is in the process of creating a new financial analysis division; once the division is operational, it will develop operating guidance that will include annual monitoring

³⁷One case study college whose sale price consisted almost entirely of intangible assets later claimed a substantial loss on those assets, citing a less optimistic regulatory outlook than previously anticipated, among other factors. Officials from this college 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.

³⁸[GAO-14-704G](#)

procedures for colleges whose conversions have been approved. Until such procedures are in place and are implemented for all newly converted nonprofit colleges, Education may miss opportunities to more effectively monitor newly converted nonprofit colleges.

In summary, my testimony has highlighted that for-profit college conversions involving insiders can pose risks to students and taxpayers. 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 its students, and violating federal requirements. IRS and Education each play an important role in ensuring that individuals do not improperly use the resources of a tax-exempt college for their personal benefit and we have identified opportunities for both agencies to improve their oversight in this area.

Chairman Scott, Republican Leader Foxx, and Members of the Committee, this completes my prepared statement. I would be pleased to respond to any questions that you may have at this time.

GAO Contact and Staff Acknowledgments

If you or your staff have any questions about this testimony, please contact Melissa Emrey-Arras, Director of Education, Workforce, and Income Security, at (617) 788-0534 or emreyarrasm@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. GAO staff who made key contributions to this testimony include Michelle St. Pierre (Assistant Director), Ellen Phelps Ranen (Analyst-in-Charge), Rachel Beers, Kelsey Kreider, and Caitlyn Leiter-Mason. Additional support was provided by James Bennett, Elizabeth Calderon, MacKenzie Cooper, Swati Deo, Holly Dye, Amy MacDonald, and Adam Wendel.

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