IRS Audits *of* Tax-Exempt Organizations

Policies, Practices, and Procedures

BRUCE R. HOPKINS

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John Wiley & Sons, Inc.

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This book is dedicated to Scott C. Syphax; he knows why.

About the Author

BRUCE R. HOPKINS is a senior partner with the firm Polsinelli Shalton Flanigan Suelthaus PC. He is also the author of more than 20 books on nonprofit tax and law issues, including *The Law of Tax-Exempt Organizations, 9th ed., Planning Guide for the Law of Tax-Exempt Organizations, Nonprofit Law Made Easy, Charitable Giving Law Made Easy, 650 Essential Nonprofit Law Questions Answered, The Law of Fundraising, 3rd ed., Private Foundations: Tax Law and Compliance, 2nd ed., The Tax Law of Charitable Giving, 3rd ed., The Law of Intermediate Sanctions*, and *The Law of Tax-Exempt Healthcare Organizations, 2nd ed.*, as well as the monthly newsletter *Bruce R. Hopkins' Nonprofit Counsel*, all published by Wiley.

Mr. Hopkins received the 2007 Outstanding Nonprofit Lawyer Award (Vanguard Lifetime Achievement Award) from the American Bar Association, Section of Business Law, Committee on Nonprofit Corporations. He is listed in *The Best Lawyers in America*, Nonprofit Organizations/Charities Law, 2007–2008.

Contents

Preface

John Wiley & Sons and yours truly have spent thousands of hours spanning more than 30 years producing over 20 books about federal and state law applicable to nonprofit organizations. Most of this work focuses on the federal tax law, with emphasis on tax exemption. Thus, by necessity, all of these books, some to a greater extent than others, pertain to law that is formulated, shaped, and enforced by your author's favorite government agency, the Internal Revenue Service.

Most books about the IRS are sensational, written to fan the populace's flames of hatred and fear of the IRS. One of the best of this genre is *Inside Internal Revenue: A Report to the Taxpayer*, written by a fellow named William Surface back in 1967 (New York: Coward-McCann, this publisher was probably audited by the IRS soon thereafter). A blurb from the dust jacket nicely sets the tone: ''Here is the first authoritative report on the biggest, toughest, and heretofore most mysterious and sacrosanct money-collecting industry on earth—the Internal Revenue Service.'' This book ''penetrates the propaganda, the scares, the innuendoes, and the threats to tell exactly how the big bite operates.'' It is elsewhere reported that this distaste of the agency predates the 1960s: ''But the fledgling nation [the United States] was soon to find its very existence threatened with the outbreak of the War of 1812 (1807–10), during which the British marched into Washington, D.C., and, with the help of local residents, burned the Internal Revenue Service to the ground. Tragically, it was rebuilt. . .'' (*Dave Barry's History of the Millennium (So Far)* (New York: G. P. Putnam's Sons, 2007) at 20). (Mr. Barry has been audited by the IRS.)

As this book was being formulated, very little in the way of serious writings about the organization and operation of the IRS existed. Authoritative information about IRS audits was, at best, skimpy. (Not that there weren't plenty of writings about IRS audits. Mr. Surface, for example, attempting to explain the agency's ''dual image'' of being helpful to compliant taxpayers (hence Internal Revenue *Service*) and simultaneously relentless in the collection of taxes and penalties, wrote that the IRS is ''comparable to a beautiful woman who unpredictably kisses and kicks with equal passion'' (at 5).)

As is discussed in this book, IRS audits of tax-exempt organizations are increasing. This is complemented by the relatively new phenomena of compliance check projects, where hundreds of exempt organizations are examined, usually as to a single issue, such as hospitals' compliance with the charity care requirement, public charities' involvement in political campaign activity, or tax-exempt bond beneficiaries' adherence to certain recordkeeping rules.

Given this lack of information and concomitant rise in the IRS exempt organizations' audit activity, conception of the need for this book was easy. Both executives and representatives of tax-exempt organizations need to know more than they usually do when caught up in an IRS examination. (There are veteran lawyers out there bearing the battle scars of exempt organization audits, but they are scarce.) When writing a book, however, there is a gap between conception and production. The breadth and depth of this gap will vary (dependent largely on the writer's organizational and disciplinary skills, and also on the availability of underlying information), but there always is one. In the case of this book, the gap was a chasm; this book, without doubt, proved to be the most difficult one that your author has written. Conception: easy; production: hard; gap: very wide and very deep.

The reason for this tribulation is as mentioned: an absence of solid information about the IRS and even less material about its tax-exempt information audit policies and practices. IRS audits are a subject few taxpayers care to contemplate; the IRS does not go out of its way to engage in discourse on the matter. Ferreting out the information that lies between these covers was quite the exercise.

The book, of course, is intended to be of assistance to those who manage tax-exempt organizations that become enmeshed in an IRS audit and those who represent the organizations (usually lawyers and/or accountants) in connection with the examination. This objective is achieved in two ways. One, the parties should understand the structure and operations of the IRS as they relate to audits of exempt organizations. Two, the parties need to know what to expect in the exempt organization audit process—how to prepare for it, how to cope with it, how to (ideally, successfully) survive it. Exempt organization audits are not precisely alike but there are plenty of commonalties. (Wonderful phrases emanate from the realm of IRS EO audits, uttered mostly by Marc Owens; two of the best pertain to proper advance preparation for an IRS audit (''hardening the target'') and being selected for an IRS audit (''winning the audit lottery''). The IRS has some intriguing phraseologies in this context as well but, somehow, they are not as entertaining.)

Unlike your author's other books, there is not much law on which this one rests. No statutes, tax regulations, court opinions, or the like guide the way and neatly formulate the process (except, as discussed in Chapter 6, for churches). (There is the formidable *Internal Revenue Manual*, more about which in Chapters 1 and 7.) Certain aspects of the audit steps are treated in detail in the law, such as the IRS's summons authority and the availability of technical advice; this book is an attempt to stitch these details together and provide the big IRS exempt organizations' audit picture. War stories are kept to a minimum, but there is a sprinkling of them to illustrate some of the snags that can pop up along the way.

Your author does not wish an IRS audit on any tax-exempt organization. Should one occur, however, this book is designed to help. To those involved, be alert, be cautious, be patient. Think of the IRS as that beautiful woman.

Thanks to my senior editor, Susan M. McDermott, for seeing me through this project with her constant encouragement, and to Natasha Andrews-Noel, production editor, for her skills in narrowing the gap and attending to production of the book.

Bruce R. Hopkins
March 2008

Book Citations

Throughout this book, eight books by the author (in some instances as co-author), all published by John Wiley & Sons, are referenced in this way:

1. *The Law of Fundraising, Third Edition* (2002): cited as *Fundraising*.
2. *The Law of Intermediate Sanctions: A Guide for Nonprofits* (2003): *Intermediate Sanctions*.
3. *The Law of Tax-Exempt Organizations, Ninth Edition* (2007): *Tax-Exempt Organizations*.
4. *The Law of Tax-Exempt Healthcare Organizations, Second Edition* (2001): *HealthCare Organizations*.
5. *Planning Guide for The Law of Tax-Exempt Organizations: Strategies and Commentaries* (2004): *Planning Guide*.
6. *Private Foundations: Tax Law and Compliance, Second Edition* (2003): *Private Foundations*.
7. *The Tax Law of Charitable Giving, Third Edition* (2005): *Charitable Giving*.
8. *The Tax Law of Unrelated Business for Nonprofit Organizations* (2005): *Unrelated Business*.

The first, third, fourth, sixth, and seventh of these books are annually supplemented. Also, updates on all of the foregoing subjects are available in *Bruce R. Hopkins' Nonprofit Counsel*, the author's monthly newsletter, also published by Wiley.

CHAPTER ONE

IRS Audits of Tax-Exempt Organizations: Fundamentals

Few systems are as hard to penetrate, for information as to procedure and substance, as the audit program of the Internal Revenue Service.[1] There is relatively little written on this subject, which perhaps is not surprising, in part because of the reluctance of the IRS to say too much about its audit policies and criteria. Much of what is written about IRS audits is found in

[1]Throughout, the Internal Revenue Service is referenced as the *IRS* or, occasionally, the *agency*.

the *Internal Revenue Manual*,[2] the text of which is often murky and difficult to navigate; being lost in bureaucratese (and translation) is a frequent experience there.[3] One fact, however, is clear: As is the case with taxpayers in general, the IRS audits tax-exempt organizations. Indeed, in recent years, this exempt organizations audit activity has been steadily increasing.[4]

§ 1.1 INTRODUCTION TO IRS EXEMPT ORGANIZATIONS' AUDIT PROCEDURES

The IRS examines, or audits, the activities and records of tax-exempt organizations. The agency states that the ''goal of the Exempt Organizations Examinations program is to promote voluntary compliance by analyzing operational and financial activities of exempt organizations.''[5] The IRS defines the term *examination* in this context to mean a ''review of books, records, and other data to develop all significant issues, to [e]nsure a proper determination of exempt status, qualification, or tax liability where appropriate, and to determine that applicable statutory requirements are satisfied.''[6]

In general, the IRS is authorized to ascertain the correctness of any return, make a return where none has been made, and determine the liability of any person for any internal revenue tax.[7] To this end, the IRS may examine any books, papers, records, or other data that may be relevant or material to its inquiry; summon persons liable for tax and/or having possession of pertinent records to appear before a representative of the agency and produce books and

[2]The IRS's Tax-Exempt Organizations Examination Procedures, a part of the *Internal Revenue Manual (IRM)*, are summarized in Chapter 5.

[3]Indeed, the mistakes in the IRM in grammar and punctuation, the misspellings, and the repetition of text (presumably not an exercise in palilogy) constitute a strange and sometimes nearly incomprehensible argot that takes, particularly when one is immediately shifting from reading other material, considerable powers of adjustment and focus to comprehend; nonetheless, once the lingo is mastered, a wealth of information is to be found. Indeed, although the level of detail can be overpowering, each IRS audit is unique and leads down hitherto-unexplored paths. Untold hours expended by your author in slogging through and wallowing around in the IRM served as a reminder that ''our minds are wonderful explanation machines, capable of making sense out of almost anything, capable of mounting explanations for all manner of phenomena, and generally incapable of accepting the idea of unpredictability'' (Taleb, *The Black Swan*, 10 (Random House 2007)).

[4]See § 1.12.

[5]IRS web site (www.irs.gov).

[6]IRM, Part 4 (''Examining Process''), Chapter 75 (''Exempt Organizations Examination Procedures''), section (§) 4. Throughout, the citations to the IRM are to the appropriate *part*, then *chapter*, then what the IRS refers to as *section*, then to material within a section, referenced in this book as ''§.'' Thus, the foregoing reference to the IRM is reflected in the following format: IRM 4.75.4 § 3.

[7]Internal Revenue Code of 1986, as amended, section (IRC) § 7602(a).

records,[8] and give relevant testimony; and take testimony of persons under oath when relevant or material to an inquiry.[9]

This examination activity is designed to assure the IRS that tax-exempt organizations are in compliance with all pertinent requirements of the federal tax law.[10] Consequently, the agency may examine a wide variety of matters, including an organization's ongoing eligibility for exempt status and public charity classification, adherence to the private inurement and private benefit doctrines, compliance with the unrelated business rules, obedience of the laws concerning attempts to influence legislation and involvement in political campaign activities, abidance with the annual return filing and disclosure requirements, and compliance with employee benefit, tax-exempt bond financing, and employment tax laws.[11]

The IRS is in a period of transition in connection with its audit procedures and practices. Until recently, IRS exempt organizations audits were in decline, largely because of a lack of resources (funds and personnel). Also, in the aftermath of the IRS reorganization,[12] many employees of the Exempt Organizations[13] Examinations Office[14] were diverted to determinations and rulings work. This workforce allocation dilemma still has not been completely resolved,[15] but progress is being made in stabilizing the staffing in both components of the EO Division.[16] Certainly the exempt organizations enforcement emphasis is being expanded. Indeed, the contemporary culture at the Division (and the IRS generally) involves concentration more on enforcement and examinations, with education and community outreach a relatively lesser priority.[17] At the same time, the IRS's examination coverage is improving as

[8]See § 1.8.

[9]IRC § 7602(a); Federal Tax Regulations (Reg.) § 301.7602-1(a). Special rules apply to churches (see Chapter 6).

[10]The IRS, in its Exempt Organizations Implementing Guidelines (see *Tax-Exempt Organizations* § 2.2(b), (c)) for fiscal year 2006, stated the matter in this fashion: its strategic plan for fiscal year 2006–2007 provides for ''improving the IRS presence in the tax-exempt organizations community to promote greater overall compliance and fairness.'' These guidelines also state that the IRS's examination program concerning exempt organizations ''will continue its focus on abuses within the EO community, increasing its coverage rate and enhancing its ability to select more productive cases for examination.''

[11]In general, see Appendix (App.) D.

[12]See § 2.2, text accompanied by notes 19–25, § 2.3, text accompanied by notes 39–41.

[13]Frequently, throughout, *EO* will be substituted for *Exempt Organizations*.

[14]See § 2.5.

[15]The IRS has a considerable backlog of applications for recognition of exemption; it is whittling away at this problem by drawing on personnel throughout the EO Division.

[16]See § 2.3.

[17]During the tenure of Mark W. Everson as the Commissioner of Internal Revenue (2003–2007), the focus of the IRS in the tax-exempt organizations context shifted dramatically to enforcement. In an e-mail message to IRS employees announcing his resignation as Commissioner, Mr. Everson wrote: ''I look back over the last four years with great pride and satisfaction. Together, we have rebalanced the organization [IRS], bringing to life the equation: *Service* + *Enforcement* = *Compliance*. This has been no small feat, and I thank all of you for doing your

the agency is developing more effective methods of allocating and deploying examination resources.[18]

The IRS developed an extensive package of guidelines and procedures for the agency's examinations of tax-exempt organizations. These procedures explain the processes for the preexamination phase, various types of examinations, the examiner's responsibilities, use of closing agreements, the team examination procedures, and more.[19] The IRS also has guidelines containing discussions of the content of examinations of exempt organizations by category of entity.[20]

Typically, an examination of a tax-exempt organization will cover a two-year period, although the IRS can expand the examination period. Because of the three-year statute of limitations period,[21] if the period is to be expanded, it is likely that more recent years will be added to the period rather than older years. An expert advised that exempt organizations ''should be very alert to the time periods under review in order to avoid inadvertently providing information for years that have not been formally placed under examination.''[22]

§ 1.2 REASONS FOR IRS AUDITS

The reasons for an IRS examination of a tax-exempt organization are manifold. The agency often focuses on particular categories of major exempt entities, such as healthcare institutions,[23] colleges and universities,[24] political organizations,[25] community foundations,[26] and private foundations.[27] Sometimes

part to restore credibility to our enforcement programs while continuing to improve taxpayer service over this period.''

[18]See § 1.13.

[19]IRM 4.75. See Chapter 5.

[20]IRM 4.76. See Chapter 7.

[21]See § 3.11.

[22]Owens, ''Standing Toe-to-Toe with the IRS,'' outline of presentation on March 3, 2005, at 133–134, *41st Annual Washington Non-Profit Legal and Tax Conference* (Washington Non-Profit Tax Conference, Inc.) (''Standing Toe-to-Toe with the IRS''). Other recent presentations on the subject of IRS audits of tax-exempt organizations include Hasson, Jr., ''Dealing with the IRS: What to Expect in a Foundation Audit,'' *34th Annual Salk Institute Seminar on Private Foundations*, May 18, 2006 (''Dealing with the IRS''); Hasson, Jr., ''New IRS Audit Techniques—What to Expect and How to Prepare,'' *32nd Annual Salk Institute Seminar on Private Foundations*, May 13, 2004 (''IRS Audit Techniques''); Owens, ''IRS Audit Workshop Part II: Surviving an IRS Audit,'' *19th Annual Conference on Representing & Managing Tax-Exempt Organizations*, Georgetown University Law Center, April 25, 2002; Mancino, ''Handling Controversies (Pre-Litigation) with the Internal Revenue Service,'' *18th Annual Conference on Representing & Managing Tax-Exempt Organizations*, Georgetown University Law Center, April 26, 2001 (''Handling Controversies with the IRS'').

[23]See App. C § I B.

[24]*Id*. § I F.

[25]*Id*. § I BB.

[26]*Id*. § V C.

[27]*Id*. § V A.

the examinations are more targeted, such as those currently involving credit counseling organizations[28] and down payment assistance organizations.[29] An examination of an exempt organization may be initiated on the basis of the size of the organization or the length of time that has elapsed since a prior audit. An examination may be undertaken following the filing of an information return or tax return,[30] inasmuch as one of the functions of the IRS is to ascertain the correctness of returns.[31] An examination (using that term in its loosest sense) may be based on a discrete issue, such as compensation practices.[32] Other reasons for the development of an examination include media reports,[33] a state attorney general's inquiry, or other third-party reports of alleged wrongdoing.[34]

§ 1.3 IRS AUDIT ISSUES: INTRODUCTION

Many reasons exist for an IRS examination of a tax-exempt organization. The contemporary reasons for an IRS audit of an exempt organization and the issues of the day in this regard are discussed elsewhere.[35] Most likely, however, an exempt organization examination will entail one or more of the following:

- The organization's initial or ongoing eligibility for exempt status. There are many aspects of this element,[36] and the components of it will vary depending on the type of organization.
- Public charity/private foundation classification.
- Unrelated business income issues.
- One or more excise tax issues.
- Whether the organization filed required returns and reports.
- Payment of employment taxes.

[28]See *Tax-Exempt Organizations* § 7.3.
[29]*Id*. § 7.5.
[30]Reg. § 601.103(b).
[31]See text accompanied by *supra* note 6. Also see § 1.7.
[32]See, e.g., § 4.2.
[33]This source of stimuli for IRS audits has been considerably augmented by reason of public access, including by means of the Internet, to annual information returns. This trend may continue now that the unrelated business income tax returns are public documents (see App. C § VIII B).
[34]As to this third reason for an IRS examination, the agency refers to these reports as containing *information items*, defined as information from internal or external sources concerning potential noncompliance with the tax law by a tax-exempt organization (IRM 4.75.5).
[35]See §§ 1.2, 1.13.
[36]See, e.g., § 7.1.

§ 1.4 IRS AUDIT PROCEDURES IN GENERAL

An IRS examination may be initiated and conducted in the field, that is, by one or more revenue agents operating out of a local IRS office. The agency will, assuming this is the approach, set the time and place of the examination; the standard the IRS is expected to follow in this regard is to make efforts to be reasonable under the circumstances, balancing the convenience of the organization with the requirements of sound and efficient tax administration.[37] The examiner or examiners are to be specialists in the law of tax-exempt organizations. The Tax Exempt and Government Entities Division in the IRS National Office[38] establishes the procedures and policies for the initiation and conduct of exempt organization examinations. These examinations are coordinated in the IRS EO Examinations unit headquartered in Dallas, Texas.

Almost always, as noted, an IRS examination of a tax-exempt organization will be of its documents and activities encompassed by two of the organization's years. In many instances (particularly where the exempt organization is a large one and/or there are many issues involved in the inquiry), the IRS will set an initial conference (sometimes termed the *opening meeting*). Once that date is confirmed, the revenue agent(s) conducting the examination will begin the process of collecting documents and other information.[39] The formal procedure is for the IRS to seek this information by submitting to the exempt organization one or more (usually the latter) written requests for documents or information, in the form of *information document requests*.[40]

The initial IDR will likely request copies of the articles of organization,[41] bylaws, minutes of board meetings, an organizational chart, an overview of the organization's accounting system or chart of accounts, and other basic information. These requests will become increasingly focused and could eventually include requests to interview one or more directors, officers, and/or employees. Following this fact-gathering phase, the revenue agent(s) will analyze the information and begin to discuss tentative findings, concerns, or issues that seem unclear. If the matters are not resolved, the audit will move into a process of formal notification of issues with attendant tax consequences, typically in the form of a *notice of proposed adjustment*.[42]

Examination activity may uncover issues for which there is a lack of clear precedent to guide the revenue agent(s). A technical advice process exists by which the headquarters function of the Exempt Organizations Division will become involved to establish an appropriate position.[43] This procedure

[37] Reg. § 301.7605-1(a)(1).
[38] See § 2.3.
[39] See, e.g., § 3.2.
[40] An IRS information document request (known as an IDR) is the subject of IRS Form 4564.
[41] See *Tax-Exempt Organizations* § 4.2.
[42] "Standing Toe-to-Toe with the IRS," at 134.
[43] See § 1.9.

includes a pre-submission process pursuant to which a consultation occurs between the revenue agent(s) conducting the examination, the tax-exempt organization involved, and headquarters personnel. An alternative to the technical advice process is provided by the Appeals Office function within the IRS.[44] Ultimately, final IRS decisions can be challenged in court.[45]

§ 1.5 TAX-EXEMPT ORGANIZATIONS' RIGHTS

A tax-exempt organization undergoing an examination has certain rights, as outlined in the IRS's ''Declaration of Taxpayer Rights.''[46] These rights are as follows (edited slightly to fit the exempt organizations' setting):

1. IRS employees will explain and protect the exempt organization's rights throughout its contact with the IRS.
2. The IRS will not disclose to anyone the information provided to it by an exempt organization, except as authorized by law. An exempt organization has the right to know why the agency is asking for information, how the IRS will use it, and what happens if the exempt organization fails to provide requested information.
3. If an employee or other representative of an exempt organization believes that an IRS employee has not treated the representative in a professional, fair, and courteous manner, the representative should tell the employee's supervisor. If the supervisor's response is not satisfactory, the representative should write to the IRS director for the appropriate area or center where the organization's annual information returns are filed.
4. An exempt organization may represent itself or, with proper written authorization,[47] have someone else represent it. The representative must be an individual allowed to practice before the IRS, such as a lawyer, certified public accountant, or enrolled agent. An exempt organization employee may be accompanied by a representative at an IRS interview. If an employee (or board member or officer) of an exempt organization is in an interview with the IRS and asks to consult with such a representative, then the IRS must stop the interview and reschedule it in most cases. An exempt organization employee or representative may make sound recordings of any meeting with IRS examination, appeal, or collection personnel, provided the IRS is so advised in writing at least 10 days prior to the meeting.

[44]See § 3.9.
[45]See § 3.13. In general, ''Standing Toe-to-Toe with the IRS,'' at 134.
[46]IRS Publication 1 (May 2005)
[47]See § 3.4.

5. An exempt organization is responsible for paying only the correct amount of any tax due under the law—no more, no less. If it cannot pay all of the tax when it is due, the organization may be able to make monthly installment payments.
6. The Taxpayer Advocate Service[48] can help if an exempt organization has tried unsuccessfully to resolve a problem with the IRS. The organization's local Taxpayer Advocate can offer it special help if it has a significant hardship as a result of a tax problem.
7. If an exempt organization disagrees with the IRS about its tax law status, the amount of its tax liability, or certain collection actions, the organization has the right to ask the Appeals Office to review the case. Ultimately, an exempt organization can ask a court to resolve the dispute.
8. The IRS will waive penalties, when allowed by law, if the exempt organization can show that it acted reasonably and in good faith or relied on the incorrect advice of an IRS employee. The IRS will waive interest that is the result of certain errors or delays caused by an IRS employee.

§ 1.6 TYPES OF IRS EXAMINATIONS

There are several types of IRS examinations of tax-exempt organizations; there are formal and informal classifications of them.

(a) Field Examinations

Common (at least historically) among the types of IRS examinations are, as noted, *field examinations*, in which one or more IRS revenue agents (typically, however, only one) review the books, records, and other documents and information of the exempt organization under examination, on the premises of the organization or at the office of its representative.[49] In general, the primary objective of an exempt organization examination is to determine whether the organization is organized and operated in accordance with its exempt function.[50] The examiner is also expected to determine the organization's liability for the unrelated business income tax, its liability for any excise taxes, whether it engaged in political activities that require filing of a return, and whether it has properly filed annual information returns, other returns, and forms.[51] The procedures require the examiner to establish the scope of the

[48]See § 2.12.

[49]Reg. § 601.105(b)(3). In one instance, an IRS agent conducted a field audit of an organization that had been recognized as a tax-exempt educational organization because of its programs to teach air safety; the examination (which led to revocation of the exemption) took place in the organization's airplane hangar (Priv. Ltr. Rul. 200709064 (May 4, 2006)).

[50]IRM 4.75 11.3.

[51]*Id*.

examination, outline when the examination will be limited in scope, state the documentation requirements imposed on the examiner, and summarize the examination techniques (such as interviews, tours of facilities, and review of books and records). The IRS, by means of its Tax Exempt Quality Measurement System, established quality standards applicable to exempt organizations examinations.[52]

(b) Office and Correspondence Examinations

The IRS has an Office/Correspondence Examination Program (OCEP) pursuant to which examiners of tax-exempt organizations conduct the examination of returns by means of an office interview or correspondence.[53] An *office interview case* is one where the examiner requests an exempt organization's records and reviews them in an IRS office; this may entail a conference with a representative of the organization.[54] This type of examination is likely to be of a smaller exempt organization, where the records are not extensive and the issues not particularly complex. A *correspondence examination* involves an IRS request for information from an exempt organization by letter, fax, or e-mail communication.[55] OCEP examinations generally are limited in scope, usually focusing on no more than three issues, conducted by lower-grade examiners. If warranted, a correspondence examination will be converted to an office or field examination.

(c) Team Examinations

For years, one of the mainstays of the IRS tax-exempt organizations examination effort was the *coordinated examination program* (CEP), which focused not only on exempt organizations but also on affiliated entities and arrangements (such as subsidiaries, partnerships, and other joint ventures) and collateral areas of the law (such as employment tax compliance and tax-exempt bond financing). The CEP approach, involving relatively sizable teams of revenue agents, was concentrated on large, complex exempt organizations, such as colleges, universities, and health-care institutions. This program was abandoned beginning in fiscal year 2003, however, and was replaced by the *team examination program* (TEP). Both the CEP and TEP approaches nonetheless share the same objective, which is to avoid a fragmenting of the exempt organization examination process by using a multiagent approach. The essential characteristics of the TEP approach that differentiates it from the CEP approach is that the team examinations are being utilized in connection with a wider array of exempt organizations, the number of revenue agents involved in each

[52] *Id*. §§ 11.2, 26.
[53] IRM 4.75.27.
[54] Reg. § 601.105(b)(2).
[55] *Id*.

examination is smaller, and the revenue agents are less likely to establish audit offices at the exempt organization undergoing an examination.

A TEP case generally is one where the tax-exempt organization's annual information return reflects either total revenue or assets greater than $100 million (or, in the case of a private foundation, $500 million). Nonetheless, the IRS may initiate a team examination where the case would benefit (from the government's perspective) from a TEP approach or where there is no annual information return filing requirement. There is a presumption that a team examination approach will be utilized in all cases meeting the TEP criteria.[56]

In a TEP case, the examination will proceed under the direction of a case manager. There will be one or more tax-exempt organizations revenue agents, possibly coupled with the involvement of employee plans specialists, actuarial examiners, engineers, excise tax agents, international examiners, computer audit specialists, income tax revenue agents, and economists. These examinations are likely to last two to three years; a postexamination critique may lead to a cycling of the examination into subsequent years. The procedures stipulate the planning that case managers, assisted by team coordinators, should engage in when starting a team examination; the procedures also provide for the exempt organization's involvement in the planning process. These procedures, of course, detail the flow of the examination.

(d) Compliance Check Projects

An overlay to the IRS program of examinations of tax-exempt organizations is the agency's *compliance check projects*, which focus on specific compliance issues. Examples of these projects are the IRS's inquiries into the levels and types of compensation provided by exempt organizations, involvement by public charities in political campaign activities, disparities between reported levels of charitable giving and fundraising costs, and compliance by exempt organizations in annual information return reporting of any involvement in excess benefit transactions.[57] Often, exempt organizations are contacted by the IRS only by mail to obtain information pertaining to the particular issue. This process may include the issuance of, in the words of the agency, ''targeted compliance notices to noncompliant organizations, with directions for taking appropriate actions.''[58]

The IRS is likely to publicly disseminate information resulting from a compliance check project, focus more fully on ostensibly noncompliant organizations, and follow up on prior inquiries. Inasmuch as a compliance check does

[56]IRM 4.75.29.3.
[57]See Chapter 4.
[58]IRS Fiscal Year 2003 Exempt Organizations Implementing Guidelines.

not usually involve an IRS review of a tax-exempt organization's books and records, it is not technically an examination. A compliance check inquiry can, however, evolve into an examination. The Exempt Organizations Compliance Unit[59] normally conducts these compliance checks.

§ 1.7 IRS AUDIT CONTROVERSY

There is uncertainty in the law of tax-exempt organizations as to whether the IRS may conduct an examination of an exempt organization in connection with a year as to which the organization has yet to file its annual information return. The IRS is of the view that it may audit an exempt entity irrespective of the filing of a return for the year involved. This issue initially surfaced when a charitable organization allegedly involved in political campaign activity resisted an IRS summons, in part on the grounds that the examination pertained to a year for which an information return had yet to be filed. In a review of the audit process, the Treasury Inspector General for Tax Administration[60] wrote that ''EO function personnel select an organization for examination based on information contained on the tax return [*sic*] filed with the Internal Revenue [Service],'' but added that, ''[h]owever, the IRS also has authority to examine a reporting period in which the tax return has not been filed and is not yet due.''[61] Subsequently, in its Political Activity Compliance Initiative procedures,[62] the IRS stated that, in examining charitable organizations to determine whether the prohibition on political campaign activities has been violated, its agents ''will not wait for a return to be filed or the tax year to end in order to initiate an examination of the organization and its activities.''[63]

Interestingly, neither party to this controversy has cited any authority for its position. The IRS would seem to have the better of this argument, if only because the statutory authority for audits by the agency states that the IRS is authorized to ascertain the correctness of a return but the IRS is independently authorized to determine the liability of a person for an internal revenue tax.[64] This issue is murkier in the political campaign activities context, however, because the law permits the IRS to determine and immediately assess any income or excise taxes due because of political campaign activity, by terminating the organization's tax year, but only in circumstances where the violation of the prohibition on this type of activity is ''flagrant.''[65] It is telling,

[59]See § 2.3(d).
[60]See § 2.1(b).
[61]TIGTA report 2005-10-035 (Feb. 2005).
[62]See § 4.4.
[63]Political Activity Compliance Initiative Procedures for 501(c)(3) Organizations (Feb. 24, 2006).
[64]See text accompanied by *supra* note 7.
[65]IRC § 6852. See *Tax-Exempt Organizations* § 23.3, text accompanied by note 134.

nonetheless, that the IRS's basic exempt organizations examinations guidelines begin by stating that they ''contain Exempt Organization procedures and instructions for researching, classifying and selecting returns and claims.''[66]

§ 1.8 IRS SUMMONS AUTHORITY

The IRS has the authority to issue summonses to compel, under threat of contempt of court, the person summoned to appear and testify or produce records identified in the summons. More technically, the IRS is authorized to summon a person liable for tax, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax, or any other person the IRS may deem proper, to appear before the IRS at a time and place named in the summons and produce such books, papers, records, or other data, and give such testimony, under oath, as may be relevant or material to such inquiry.[67] The purposes for which the IRS may issue a summons include the purpose of ''inquiring into any offense connected with the administration or enforcement of the internal revenue laws.''[68]

In general, the IRS may not contact any person, other than the taxpayer, with respect to the determination or the collection of the tax liability of the taxpayer without providing reasonable notice to the taxpayer that contacts with others may be made.[69] The agency is required to periodically provide to a taxpayer a record of persons contacted during a particular period by the IRS with respect to the determination or collection of a tax liability; this record must also be provided to a taxpayer on request.[70]

A summons must be served by an IRS representative, by an attested copy delivered in hand to the person to whom it is directed, or left at his, her, or its usual place of abode; the certificate of service signed by the individual serving the summons is evidence of the facts it states at any hearing in connection with an application for the enforcement of the summons. When the summons requires the production of books, papers, records, or other data, it shall be sufficient if such items of information are described with ''reasonable certainty.''[71] A summons for the production of information and/or items by a third-party recordkeeper may also be served by certified or registered mail to the last known address of the recordkeeper.[72]

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[66]IRM 4.75.4 § 1.
[67]IRC § 7602(a)(2).
[68]IRC § 7602(b).
[69]IRC § 7602(c)(1).
[70]IRC § 7602(c)(2).
[71]IRC § 7603(a); Reg. § 301.7603-1.
[72]IRC § 7603(b)(1). For this purpose, the term *third-party recordkeeper* includes banks and other savings institutions, consumer reporting agencies, certain extenders of credit, brokers, lawyers, and accountants (IRC § 7603(b)(2)). Also, IRC § 7609; Reg. § 301.7609-1.

Once a person receives one of these administrative summons, the U.S. district court for the district in which the person resides or is found has jurisdiction ''by appropriate process'' to compel the person's attendance, testimony, and/or production of documents.[73] In a case of neglect or refusal to comply with a summons, the IRS may seek to enforce it in court, as a matter of contempt. The court may make such order as it deems appropriate to enforce ''obedience to the requirements of the summons and to punish such person for his default or disobedience.''[74]

§ 1.9 TECHNICAL ADVICE

IRS Chief Counsel—most pertinently, the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities)[75]—issues, from time to time, technical advice memoranda (TAMs) to a director or an appeals area director.[76] The general term *technical advice* means advice furnished by the Office of Chief Counsel in a memorandum that responds to any request, properly submitted, for assistance on any technical or procedural question that develops during a proceeding before the IRS. An IRS field office[77] may request a TAM when the application of the law to the facts involved is unclear. The question must be on the interpretation and proper application of tax statutes, treaties, regulations, revenue rulings, notices, or other precedents to a specific set of facts that concerns the treatment of an item in a year under examination or appeal. A TAM may not be requested for prospective or hypothetical transactions. Technical advice does not include oral legal advice

[73]IRC § 7604(a).

[74]IRC § 7604(b); Reg. § 301.7604-1. To enforce an administrative summons, the IRS must show that the investigation is being conducted for a legitimate purpose, the summons seeks information that is relevant to that purpose, the IRS does not already possess the information, and the IRS has followed the proper procedural steps in issuing and serving the summons (*United States v. Powell*, 379 U.S. 48, 57–58(1964)). There are dozens of appellate court opinions on these points (e.g., *United States v. Rockwell Int'l*, 897 F.2d 1255 (3rd Cir. 1990); *United States v. Garden State Nat'l Bank*, 607 F.2d 61 (3rd Cir. 1979)). There are untold numbers of district court opinions concerning the IRS summons issuance authority; one of the most recent and comprehensive of these (not involving a tax-exempt organization) related the misadventures of a hapless taxpayer with the unfortunate (from the taxpayer's standpoint) surname of ''Badman'' who was relentlessly (and successfully) pursued by exercise of summons authority by IRS revenue agent Donna Lamonna (*Badman v. Internal Revenue Service*, 99 A.F.T.R 2d 590 (M.D. Pa. 2007)).

[75]There are seven Offices of Associate Chief Counsel that issue TAMs; these are collectively termed *Associate offices* (Rev. Proc. 2007-2, 2007-1 I.R.B. 88 § 2.06).

[76]The IRS's general procedures (issued annually) as to when and how TAMs will be issued, and the rights that a taxpayer has when a field office requests a TAM, are currently provided in Rev. Proc. 2007-2, 2007-1 I.R.B. 88. The procedures (also issued annually) for requesting technical advice on issues under the jurisdiction of the Commissioner, Tax Exempt and Government Entities Division, are the subject of Rev. Proc. 2007-5, 2007-1 I.R.B. 161 (Rev. Proc. 2007-2, 2007-1 I.R.B. 88 § 4.02).

[77]The term *field office* means personnel in any IRS examination or Appeals office (Rev. Proc. 2007-2, 2007-1 I.R.B. 88 § 2.07).

or any written legal advice furnished to the field office that is not submitted and processed in accordance with IRS procedures.[78] Taxpayers[79] are afforded an opportunity to participate in the TAM process; taxpayer participation is preferred but not required in order to process a request for technical advice.[80]

(a) General Procedures in Exempt Organizations Context

The TAM procedures specifically applicable in the tax-exempt organizations setting explain when and how EO Technical issues TAMs to an EO Examinations[81] Area manager, an EO Determinations manager, or an Appeals Area Director, Area 4 (in exempt organizations contexts).[82] Thus, these procedures apply to requests for TAMs on any issue under the jurisdiction of the Commissioner, Tax Exempt and Government Entities.[83] These procedures also explain the rights a taxpayer has when one of these three components of the IRS requests a TAM.[84] Again, although taxpayer participation during all stages of the process is preferred, it is not required in order to request technical advice.[85]

In the tax-exempt organizations context, the term *technical advice* means advice or guidance in the form of a memorandum furnished by the Exempt Organizations Technical office at the request of one of these three components of the IRS, submitted in accordance with the procedures in response to any technical or procedural question that develops during any proceeding on the interpretation and proper application of the federal tax law, including regulations, revenue rulings, and notices, published by the IRS National Office (or *headquarters*) to a specific set of facts. These proceedings include the examination of an organization's return; consideration of an organization's claim for refund or credit; an organization's request for a determination letter; any other matter involving a specific taxpayer under the jurisdiction of EO Examinations, EO Determinations, or an appeals office; or processing or considering nondocketed cases of a taxpayer in an appeals office. TAMs assist IRS personnel in resolving complex issues, and help establish and maintain consistent holdings throughout the agency.[86]

Exempt Organizations Examinations, Exempt Organizations Determinations, and appeals offices are required to request a TAM in connection with

[78]Rev. Proc. 2007-2, 2007-1 I.R.B. 88 § 3.01.

[79]The term *taxpayer* means any person subject to any provision of the Internal Revenue Code (Rev. Proc. 2007-2, 2007-1 I.R.B. 88 § 2.05), including a tax-exempt organization (Rev. Proc. 2007-5, 2007-1 I.R.B. 161 § 3).

[80]Rev. Proc. 2007-2, 2007-1 I.R.B. 88 § 3.03.

[81]See § 2.5.

[82]These procedures also are applicable with respect to TAMs issued in the employee plans setting.

[83]Rev. Proc. 2007-5, 2007-1 I.R.B. 161 § 4.01.

[84]*Id*. § 1.01.

[85]*Id*. § 1.02.

[86]*Id*. §§ 3, 4.03.

cases concerning qualification for tax exemption or public charity/private foundation status as to which there is no published precedent or for which there is reason to believe that nonuniformity exists.[87] Thus, a TAM should be requested ''when there is a lack of uniformity regarding the disposition of an issue or when an issue is unusual or complex enough to warrant consideration'' by EO Technical.[88] A request for a TAM is not required if the Director, EO Examinations, proposes to revoke or modify (1) a letter ruling found to be in error or not in accord with the current views of the IRS or (2) a letter recognizing exempt status issued by the IRS headquarters office.[89]

The EO Examinations Area manager, the EO Determinations manager, or the Appeals Area Director, Area 4, determines whether to request a TAM on an issue. Each request must be submitted through ''proper channels.''[90] While a case is under the jurisdiction of EO Examinations, EO Determinations, or the Appeals Area Director, Area 4, a taxpayer may request that an issue be referred to the EO Technical office for a TAM.[91] EO Examinations or EO Determinations may not request a TAM on an issue if an appeals office is currently considering an identical issue concerning the same (or a related) taxpayer.[92] A case remains under the jurisdiction of EO Examinations or EO Determinations even though an appeals office has the identical issue under consideration in the case of another (unrelated) taxpayer in an entirely different transaction. With respect to the same taxpayer or the same transaction, when the issue is under the jurisdiction of an appeals office, and the applicability of more than one type of federal tax is dependent on the resolution of that issue, EO Examinations or EO Determinations may not request a TAM on the applicability of any of the taxes involved.[93]

Once an issue is identified, all requests for a TAM should be made at the ''earliest possible stage'' in the proceeding. The fact that an issue is raised late in the examination, determination, or appeals process, however, should not influence a decision, by a component of the IRS, to request a TAM.[94]

(b) Pre-Submission Conferences

EO Technical generally will discuss the issue(s) with EO Examinations, EO Determinations, or the appeals office, and the taxpayer, prior to the time any request for technical advice is formally submitted. In general, a pre-submission conference is mandatory.[95] These conferences are intended

[87] *Id*. § 4.04.
[88] *Id*. § 8.10.
[89] *Id*. § 4.04.
[90] *Id*. § 7.01.
[91] *Id*. § 7.02.
[92] *Id*. § 8.02(1).
[93] *Id*. § 8.02(2).
[94] *Id*. § 8.03.
[95] *Id*. § 9.01.

to facilitate agreement between the parties as to the appropriate scope of the request for a TAM or any collateral issues that should or should not be included in the request for a TAM, and any other substantive or procedural considerations that will allow EO Technical to provide the parties with a TAM as expeditiously as possible.[96] A request for a pre-submission conference must be submitted in writing; it should include a brief explanation of the primary issue so that an assignment to the appropriate group can be made.[97]

Within 5 working days after it receives the request, the group assigned responsibility for conducting the pre-submission conference is to contact the IRS component that submitted the request to arrange a time for the parties to meet (likely by telephone). This conference generally should be held within 30 calendar days after the IRS component is contacted. The IRS component involved has the responsibility for coordinating the matter with the taxpayer.[98]

At least 10 working days before the scheduled pre-submission conference, the IRS office involved and the tax-exempt organization should submit to EO Technical a statement of the pertinent facts, a statement of the issues that the parties would like to discuss, and any legal analysis, authorities, or background documents that the parties believe would facilitate understanding of the issues to be discussed at the conference.[99] Generally, these materials must be submitted electronically.[100]

(c) Contents of TAM Requests

A request for a TAM must include statements of the facts and the issues for which the TAM is requested, and statements that ''clearly'' set forth the applicable law and arguments in support of the IRS's and the tax-exempt organization's position on the issue or issues.[101] If the exempt organization initiates a request for a TAM, it must submit to the EO specialist or appeals office, at the time the request is made, a written statement that:

- States the facts and the issues
- Explains the organization's position
- Discusses any relevant statutory provisions, court decisions, regulations, revenue rulings, revenue procedures, notices, or other authority supporting the organization's position
- States the reasons for requesting technical advice[102]

[96] *Id*. § 9.02.
[97] *Id*. § 9.03.
[98] *Id*. § 9.04.
[99] *Id*. § 9.06.
[100] *Id*. § 9.07.
[101] *Id*. § 10.01.
[102] *Id*. § 10.01(1).

If a request for a TAM is initiated by the IRS, the exempt organization involved is ''encouraged'' to submit this written statement.[103]

Tax-exempt organizations in this process are ''encouraged'' to comment on any legislation, regulations, revenue rulings, revenue procedures, or court decisions that are contrary to their position. If the organization determines that there are no contrary authorities, a statement to this effect would, from the IRS's perspective, be ''helpful.'' If an exempt organization does not furnish contrary authorities or a statement that none exist, the IRS, in ''complex cases or those presenting difficult or novel issues,'' may request submission of contrary authorities or a statement that none exist.[104]

(d) Handling of TAM Requests

After receiving the tax-exempt organization's statement of the areas of disagreement, ''every effort'' is to be made to reach agreement on the facts and points at issue before the matter is referred to EO Technical. If an agreement cannot be reached, the IRS component involved will notify the organization. Within 10 calendar days after receiving this notice (or following an extension of time), the organization may submit a statement of its understanding of the facts and issues. Both the organization's and the IRS's statements will be forwarded to EO Technical with the request for a TAM.

When the parties cannot agree on the material facts, and the request for a TAM does not involve the issue of whether a letter ruling or determination letter should be modified or revoked, EO Technical, at its discretion, may refuse to provide technical advice. If EO Technical chooses to issue the TAM, it will base its advice on the facts provided by the IRS. If a request for a TAM involves the issue of whether a letter ruling or determination letter should be modified or revoked, EO Technical will issue the TAM.[105] A similar procedure applies where the exempt organization initiates the TAM request.[106]

(e) Appeals of Decisions to Not Seek Advice

If the EO specialist's or appeal's referral of an issue to EO Technical for a TAM is not warranted, the tax-exempt organization will be so advised.[107] The exempt organization may request review of this decision; this is done by submission, within 10 calendar days thereafter (or pursuant to an extension of time), of a statement of the facts, law, and arguments on the issue and the reasons why the organization believes the matter should be referred for a TAM.[108] If the IRS manager or chief determines that a TAM is unwarranted

[103] *Id*. § 10.01(2).
[104] *Id*. § 10.01(3).
[105] *Id*. § 11.04.
[106] *Id*. § 11.05.
[107] *Id*. § 12.01.
[108] *Id*. § 12.02.

and proposes to deny the request, the exempt organization is so advised by letter; the organization has 10 calendar days thereafter to notify the IRS of its agreement or disagreement with the proposed denial.[109]

This decision may not be appealed. It may, however, be submitted for review by the Commissioner, Tax Exempt and Government Entities, or the Director, Appeals, Technical Services. A 45-day review process will thereafter ensue, with the tax-exempt organization then notified of the outcome.[110]

(f) Withdrawal of TAM Requests

Once a request for a TAM has been sent to EO Technical, only an EO Examinations Area manager, an EO Determinations manager, or the Appeals Area Director, Area 4, may withdraw the request. Generally, the IRS will notify the tax-exempt organization involved of that decision. If the exempt organization does not agree that the TAM request should be withdrawn, the appeal procedure is to be followed.[111]

When a request for a TAM is withdrawn, EO Technical may send its views to the EO Examinations office, the EO Determinations office, or the Appeals Area Director, Area 4, when acknowledging the withdrawal request. In an appeals case, acknowledgment of the withdrawal request is to be sent to the appropriate appeals office. In ''appropriate'' cases, the subject matter may be published as a revenue ruling or a revenue procedure.[112]

(g) Conference Scheduling

If, after the TAM is analyzed, it appears that a TAM adverse to the tax-exempt organization will be given, and if a conference has been requested, the organization will be informed, by telephone if possible, of the time and place of the conference.[113] The conference for a TAM must be held within 21 calendar days after the exempt organization is contacted, absent an extension of this period.[114] If conferences are being arranged for more than one request for a TAM for the same organization, they will be scheduled to ''cause the least convenience'' to the organization. If considered appropriate, EO Technical will notify the EO specialist or the appeals office of the scheduled conference and will offer the specialist or appeals officer the opportunity to attend the conference. The Commissioner, Tax Exempt and Government Entities, the Chief, Appeals, the EO Examinations Area manager, the EO Determinations

[109] *Id*. § 12.03.
[110] *Id*. § 12.04.
[111] *Id*. § 13.01. See § 1.9(e).
[112] Rev. Proc. 2007-5, 2007-1 I.R.B. 161 § 13.02.
[113] *Id*. § 14.01.
[114] *Id*. § 14.03.

manager, or the Appeals Area Director, Area 4, may designate other IRS representatives to participate in the conference.[115]

Following an IRS explanation of the agency's tentative decision,[116] one or more additional conferences may be held.[117] The organization may be accorded the opportunity to make an additional submission within 21 calendar days (unless an extension of this time period is obtained).[118]

(h) IRS Use of TAMs

The EO Examinations Area manager, the EO Determinations manager, or the Appeals Area Director, Area 4, must process the tax-exempt organization's case on the basis of the conclusions in the TAM, unless:

- The appropriate IRS component of the three decides that the conclusions reached by EO Technical in the TAM should be reconsidered, or
- The Appeals Area Director, Area 4, in the case of a TAM that is unfavorable to the exempt organization, decides to settle the issue in the ''usual manner under existing authority.''

Subject to a request for reconsideration of the conclusions in a TAM, EO Examinations or EO Determinations is required to follow the conclusions in a TAM as to all issues and the Appeals Area Director, Area 4, must follow the conclusions in a TAM on issues of an organization's status or qualification. Thus, if the TAM received by EO Examinations or EO Determinations concerns an organization's status or qualification, the organization has no appeal to the appeals office on those issues.[119]

The EO Examinations office, the EO Determinations office, or the Appeals Area Director, Area 4, has 30 calendar days after receipt of a TAM to formally request reconsideration or give the TAM to the tax-exempt organization. Requests for TAM reconsideration must describe with specificity the errors in the TAM analysis and conclusions. These requests should not reargue points raised in the initial request but rather should focus on any points that the TAM overlooked or misconstrued in the arguments by one of the three IRS components in support of their request. The National Office may request further submissions from the field or the exempt organization; the parties should not make any additional submissions in the absence of such a request. If the field does not request reconsideration of a TAM, the TAM will take effect when the field provides a copy of it to the exempt organization or at the end of the 30-day period following the issuance of the TAM to the field.[120]

[115] *Id*. § 14.02.
[116] *Id*. § 14.08.
[117] *Id*. § 14.09.
[118] *Id*. § 14.10.
[119] *Id*. § 17.01.
[120] *Id*. § 17.02.

EO Technical will not discuss the contents of the TAM with the tax-exempt organization or a representative of it until the organization has been provided a copy of the memorandum by the EO Examinations office, the EO Determinations office, or the appeals office.[121] Also, the exempt organization has the opportunity to protest the disclosure of certain information in the TAM.[122]

(i) Effect of TAM

A tax-exempt organization may not rely on a TAM issued by the IRS for another taxpayer.[123] Except when stated otherwise, a holding in a TAM is applied retroactively, unless the Commissioner, Tax Exempt and Government Entities, exercises discretionary authority to limit the retroactive effect of the holding.[124] A holding that modifies or revokes a holding in a prior TAM is applied retroactively, with one exception: If the new holding is less favorable to the tax-exempt organization than the previous one, it generally is not applied to the period when the organization relied on the prior holding in situations involving continuing transactions.[125]

(j) Limited Retroactive Effect of TAM

The Commissioner of Internal Revenue, or the Commissioner's designee, has the discretion to prescribe the extent, if any, to which a TAM will be applied without retroactive effect.[126] A taxpayer who has received a TAM or for whom a TAM request is pending may request that the Commissioner, Tax Exempt and Government Entities (the delegate of the Commissioner of Internal Revenue), exercise this discretionary authority to limit the retroactive effect of any holding stated in the TAM, which may still be pending or which has been issued, or to limit the retroactive effect of any subsequent modification or revocation of a TAM.[127]

When, during the course of an examination of a tax-exempt organization's return by EO Examinations or consideration by the Appeals Area Director, Area 4, the organization is informed that either component of the IRS recommends that a TAM be modified or revoked, a request to limit the retroactive application of the modification or revocation of the TAM must itself by made in the form of a request for a TAM. The organization must submit a statement, indicating the relief requested and providing the reasons and arguments in support of the request; this statement must be accompanied by any documents bearing

[121] *Id*. § 17.03.
[122] *Id*. § 17.05.
[123] *Id*. § 18.01.
[124] *Id*. § 18.02.
[125] *Id*. § 18.03.
[126] *Id*. § 19.01. This authority is accorded by IRC § 7805(b). See § 1.12.
[127] Rev. Proc. 2007-5, 2007-1 I.R.B. 161 § 19.02.

on the request. This request and statement must be forwarded by the office of EO Examinations or the Appeals Area Director, Area 4, to the office of EO Technical for consideration.[128]

When a request for a TAM concerns only the issue of limitation of retroactive application, the tax-exempt organization has the right to a conference in the office of EO Technical. If the request for this limitation is included in the request for a TAM on the substantive issues or is made before the conference of right on those issues, the issues as to limitation on retroactive applicability will be discussed at that conference. If the request for the limitation is made as part of a pending TAM request after a conference has been held on the substantive issues, and the IRS determines that there is justification for having delayed the request, the exempt organization will have the right to one conference of right concerning the issue of retroactivity, with the conference limited to discussion of this issue.[129]

Where a TAM has been requested pursuant to a tax-exempt organization's request for relief as to retroactivity from the retroactive application of an adverse determination in connection with the declaratory judgment rules,[130] the exempt organization's administrative remedies will not be considered exhausted until the office of EO Technical has a reasonable time to act on the request for a TAM.[131]

(k) Future Use of TAMs

Use of the technical advice procedure is on the decline. This is largely due to the complexities that have accreted in the TAM process over the years and the resulting long lengths of time needed to secure a TAM. From a tax-exempt organization's perspective, an effort to secure a TAM can be expensive. Also, the IRS has become more creative in the use of closing agreements as alternatives to TAMs.[132] Nonetheless, revenue agents contact personnel in the Exempt Organizations Technical's office for informal legal advice on an ongoing basis.[133]

§ 1.10 CLOSING AGREEMENTS

The closing agreement is a useful tool for resolving disputes between tax-exempt organizations and the IRS. Closing agreements, authorized by

[128] *Id*. § 19.04.
[129] *Id*. § 19.06.
[130] See § 3.13(b).
[131] Rev. Proc. 2007-5, 2007-1 I.R.B. 161 § 19.08.
[132] See § 1.10.
[133] A lawyer noted that the IRS is ''aggressively reducing the number of technical advice requests through a program of informal advice from specialists in the Headquarters office'' (IRS Audit Techniques, at 2).Technical advice does not, however, include verbal legal advice (Rev. Proc. 2007-5, 2007-1 I.R.B. 161 § 3).

statute in 1976, are being used with increasing frequency to resolve a variety of exempt organizations matters. This is particularly the case as utilization of the technical advice procedure declines.[134] As two IRS officials nicely wrote, a closing agreement in the exempt organizations context is a ''remedy for ambivalent conditions.''[135]

(a) Overall Purpose of Closing Agreements

While not the solution for every disagreement with the IRS, a closing agreement ''can be a pragmatic method to resolve sensitive matters in which there are mitigating circumstances.'' From the standpoint of the IRS, closing agreements ''promote compliance'' while conserving the IRS's ''scarce resources.'' The agency is able to resolve a compliance problem that otherwise would ''consume time and resources (through the revocation or assessment process) and obtains a commitment to future compliance.'' The exempt organization ''obtains both certainty that the matter is concluded once and for all and guidance on how to comply in the future.''

In some instances, the infractions discovered by the IRS in the course of an examination of a tax-exempt organization (or perhaps brought to the attention of the agency by an exempt organization) are ''marginal violations of mechanical limits that do not substantially hinder the organization's beneficial operations.'' In this type of context, the ''standard solutions'' available to the IRS, such as revocation of tax exemption, ''may be too harsh.''[136] These solutions ''may seriously impair the organization's ability to function or even put it out of business.'' A closing agreement ''gives the [IRS] the leeway to limit the penalty for past transgressions if the [exempt organization] will commit to future compliance.''

(b) Authority and Function

The IRS is authorized to enter into a written agreement with any person to make a final resolution of any of the person's tax law issues or tax liabilities for any tax period.[137] A closing agreement must be prepared in accordance with

[134]See § 1.9.

[135]Bloom & Miller, ''Closing Agreements,'' Exempt Organizations Continuing Professional Education Text for Fiscal Year 1993, Topic L (Closing Agreements). All quotations in this § 1.10(a) are from Closing Agreements.

[136]The statutory law is evolving in this direction as well. For example, the IRS may apply the intermediate sanctions excise tax penalties (IRC § 4958) rather than revoke exemption because of private inurement, may apply an excise tax (IRC § 4912) rather than revoke exemption because of excessive lobbying by a charitable organization, or may apply an excise tax (IRC § 4955) rather than revoke exemption because of political campaign activity by a charitable organization where the activity is insubstantial and not ongoing. Also IRC § 664(c) (imposing an excise tax on charitable remainder trusts for incurring unrelated business taxable income, rather than loss of exemption). In general, see App. C §§ II D, F; III A; IV A; XIII D.

[137]IRC § 7121(a); Reg. § 301.7121-1(a).

the IRS's form.[138] The ''key determinants governing the election of'' closing agreements[139] are:

- Appearance of an advantage in having the case permanently and conclusively closed, or
- Good and sufficient reasons on the part of the exempt organization for desiring a closing agreement and a determination by the IRS that the federal government will sustain no disadvantage through consummation of the agreement.[140]

(c) Scope

A closing agreement may be executed even though, under the agreement, the taxpayer is not liable for any tax for the period to which the agreement relates. There may be a series of closing agreements relating to the tax liability for a single period.[141]

If it is for a tax period ended before the date of the agreement, a closing agreement can cover the entire tax liability of a taxpayer for one or more years or be limited to one or more separate items affecting the tax liability of the taxpayer.[142] A closing agreement may also cover future periods; in such an instance, the agreement will be limited to one or more separate items affecting the tax liability of the taxpayer.[143]

In appropriate cases, taxpayers may be asked to enter into a closing agreement as a condition of issuance of a letter ruling. It is not necessary that the closing agreement be concluded before the letter ruling is issued; the ruling can be conditioned on the subsequent closing agreement.[144]

A closing agreement may cover a class of taxpayers. This type of agreement would be unusual in the tax-exempt organizations context, although it could apply to a group of related organizations or organizations under a group exemption.[145] If a class closing agreement is appropriate, individual agreements with each person in the class will be negotiated only in cases

[138]Reg. §§ 301.7121-1(d)(1); 601.202(b). The elements of a closing agreement are summarized in Closing Agreements. The general procedures for executing closing agreements, which can be adapted to tax-exempt organizations cases, are stated in Rev. Proc. 68-16, 1968-1 C.B. 770. The form that is generally used in exempt organizations instances is Form 906 (Closing Agreement as to Final Determination Covering Specific Matters).

[139]Closing Agreements.

[140]Reg. § 301.7121-1(a). As is pointed out in Closing Agreements, ''there need be no showing that the resulting closing agreement will confer an advantage on the United States.''

[141]Reg. § 301.7121-1(b)(1).

[142]Reg. § 301.7121-1(b)(2).

[143]Reg. § 301.7121-1(b)(3). As is noted in Closing Agreements, ''determining the entire tax liability for future periods is too speculative.''

[144]Closing Agreements.

[145]As to the latter, see *Tax-Exempt Organizations* § 25.6.

where the class consists of no more than 25 persons. If the issue and holding are the same for all members of the class and there are more than 25 persons, the IRS will enter into a ''mass closing agreement'' with the taxpayer who is authorized to represent the class.[146]

(d) Finality

A closing agreement that is timely approved is ''final and conclusive,'' and, unless there is a showing of fraud, malfeasance, or misrepresentation of a material fact, it cannot be reopened as to the matters agreed on or modified by a representative of the federal government.[147] Moreover, in any ''suit, action, or proceeding,'' a closing agreement or any ''determination, assessment, collection, payment, abatement, refund, or credit'' made in accordance with the agreement may not be ''annulled, modified, set aside, or disregarded.''[148] A closing agreement with respect to a tax period ending subsequent to the date of the agreement, however, is subject to a change in the law enacted after that date and made applicable to the period; a recitation of this rule must be in each agreement.[149]

A court may review the facts underlying a closing agreement and determine the existence of any element that may disqualify the agreement. This review may involve examination of a tax-exempt organization's books and records. The burden of proof in establishing any such disqualifying factor is on the party seeking to set the agreement aside.[150]

(e) Closing Agreements in Exempt Organizations Context

Favorable occasions for executing closing agreements in the tax-exempt organizations context are those in which revocation of tax exemption would be supported by the facts but is or appears to be ''harsh or excessive.''[151] An example of this is where revocation for ''narrow technical infractions would jeopardize the organization's ability to continue its charitable operations,'' if, in the IRS's judgment, the ''technical flaws could be eliminated definitively through changes in the organization's operations or procedures.'' By contrast, ''if it is apparent that an organization has engaged in flagrant and continuous acts compelling revocation and has not been operating in good faith, then the closing agreement is not a practical remedy.''

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[146]Closing Agreements. In general, as to this subsection, Reg. § 601.202(a)(2).
[147]Reg. §§ 301.7121-1(c)(1); 601.202(a)(1).
[148]Reg. § 301.7121-1(c)(2). ''Simple unintentional errors are not treated as fraud, malfeasance, or misrepresentations that allow [for a] reopening of an agreement'' (Closing Agreements).
[149]Reg. § 301.7121-1(c).
[150]Closing Agreements.
[151]*Id*. All quotations in this § 1.10(e) are from Closing Agreements.

Some hypothetical situations where a closing agreement ''might be a useful procedure'' are as follows:

A closely controlled charitable organization was, essentially, funded by one individual. This organization was operated out of the founder's home and accumulated assets that may not be readily segregated from the founder's personal assets because of ''functional duality of certain cooperatively employed assets'' (such as the home and an automobile). Funds of the exempt organization might be commingled with the founder's personal funds. The founder applied all of the funds to operate the exempt organization and provide for his personal living expenses, either in lieu of a salary or supplemental to a nominal salary that does not cover exempt organization-related expenses.

In a case like this, where there is no ''avaricious intent'' on the part of the founder, it may be possible to execute a closing agreement that would result in a well-defined accounting system that would be more reflective of the personal and exempt function areas.

Certain hospitals or universities are meeting a legitimate community need but a few executives have used their positions for personal gain. These transgressions have not ''discernibly diminished'' the organization's benefits to the community. It should be possible to reach an agreement with these institutions to curtail the ''offending behavior'' or remove the ''offending individuals'' without depriving the community of the organizations' valued services.

Hospitals have been known to dump patients, that is, to ''divert'' emergency patients who are uninsured and unable to pay to other, more accessible, hospitals.[152] This practice may be identified during an IRS examination. News reports or complaints about patient-dumping may have led to initiation of the examination. Dumping is contrary to the requirement that tax-exempt hospitals accept charity patients to the extent of their financial resources. If an exempt hospital's dumping practice, however, is not ''pervasive'' and not the result of a ''generally hostile attitude'' toward the treatment of indigents or cases involving no reimbursement, the hospital might be afforded the opportunity to formally rescind and reverse the policy by means of a closing agreement.

Charitable organizations may inadvertently advertise full deductibility of amounts paid to them at fundraising events, such as admission to entertainment or recreational activities, or sales of products. Likewise, a tax-exempt school may have promulgated the erroneous notion that parents may deduct a portion of their child's tuition as a charitable contribution. In many cases, these incidents are one-time occurrences, not reflective of a ''willful intent to defraud prospective donors or patrons,'' and can be cured by execution of a closing agreement.

In the case of a tax-exempt social club,[153] where there is a ''marginal failure'' to adhere to the percentage limitations on nonmember income, and substantially all of the club's other activities further exempt purposes, a closing agreement might be negotiated, pursuant to which the organization would agree to reduce its nonmember activities within a certain period of time. An agreement, where the club paid unrelated business income tax on all investment and other nonmember income during the tax periods under examination and agree to discontinue the activity

[152]See *Tax-Exempt Healthcare Organizations* § 35.2.

[153]That is, an organization described in IRC § 501(c)(7). See App. C § I N.

and/or maintain more reliable records accurately reflecting member income, might be appropriate.[154]

In the case of a tax-exempt veterans' organization,[155] a situation might arise where the organization ''narrowly fails'' the percentage-of-membership test[156] through ''interpretative difficulties.'' A closing agreement arrangement might enable the organization to, during a negotiated period, ''correct its roster.''

A large, tax-exempt hospital system is the sole source of comprehensive health care for the communities it serves. The system engaged in a joint venture with its physicians, in which it sold its net revenue stream from some of its activities to the venture, thereby jeopardizing its exemption on the grounds of private inurement and private benefit.[157] Loss of exemption would force the hospital to curtail some aspects of its charitable operations or perhaps close. Rather than deprive the community of a vital asset because of what essentially is a one-time violation, it would be more appropriate to allow the offending hospital the opportunity to rescind the arrangement and institute procedures to preclude similar problems in the future. This resolution of the issue could be accomplished by means of a closing agreement.[158]

§ 1.11 FREEDOM OF INFORMATION ACT

The Freedom of Information Act (FOIA) provides basic rules for disclosure of federal records;[159] this law is applicable to the IRS. Nonetheless, there are several exceptions to the FOIA. One of these exceptions is for documents specifically exempted by statute (known as *FOIA Exemption 3*).[160] The basic rule in the federal tax law context requires disclosure by the IRS of documents pertaining to applications for recognition of tax-exempt status.[161] By contrast, federal tax law explicitly protects the confidentiality of certain tax return information, such as closing agreements, as long as the return information is not subject to disclosure under the general rule.[162] In an opinion analyzing the intersection of these two federal tax law rules, a federal court of appeals held

[154]The penalty in this example seems unduly harsh. The payment of unrelated business income tax and/or the discontinuance of an activity or practice need apply only to the extent the income exceeds the applicable percentage threshold; the penalty should not extend to all of the income, inasmuch as receipt of income below the threshold is permissible.

[155]That is, an organization described in IRC § 501(c)(19). See *Tax-Exempt Organizations* § 19.11.

[156]*Id*., text accompanied by notes 237, 253, 254.

[157]See App. C §§ II D, E.

[158]This last example is no mere hypothetical. It is reflective of one of the most well-known closing agreements executed in the tax-exempt organizations context; it involved the Hermann Hospital in Houston, Texas. See *Tax-Exempt Healthcare Organizations* § 26.6 and App. B of that book (reproducing the agreement).

[159]5 U.S.C. § 552(a).

[160]5 U.S.C. § 552(b)(3).

[161]IRC § 6104(a)(1)(A). See *Tax-Exempt Organizations* § 27.8(a), text accompanied by note 231.

[162]IRS § 6103(b)(2)(D). See *Tax-Exempt Organizations* § 27.8(a), text accompanied by note 229. A federal appellate court concluded that the fact that IRC § 6103 is a statute ''contemplated by FOIA Exemption 3 is beyond dispute'' (*Tax Analysts v. Internal Revenue Service*, 117 F.3d 607, 611 (D.C. Cir. 1997)).

that FOIA Exemption 3 shielded from disclosure a closing agreement between the IRS and a tax-exempt organization.[163]

Another exception in this setting incorporates the traditional attorney work product doctrine by exempting from the general rule of disclosure any documents ''which would not be available by law to a party . . . in litigation with the agency'' (known as *FOIA Exemption 5*).[164] The FOIA, however, does not provide complete protection for documents containing privileged material; the governmental agency must disclose any reasonably segregable nonexempt portions of a record unless they are ''inextricably intertwined'' with the exempt portions.[165] For example, IRS technical advice memoranda may be shielded from disclosure pursuant to this exception where they are documents prepared in anticipation of litigation or for trial (even if they contain a discussion of general applications of the federal tax law).[166] The same is the case for IRS Field Service advice memoranda[167] and Chief Counsel advice memoranda.[168]

§ 1.12 RETROACTIVE REVOCATION OF TAX-EXEMPT STATUS

The IRS has the authority to retroactively revoke a ruling as to an organization's tax-exempt status.[169] An exemption ruling or determination letter may be retroactively revoked or modified if the organization omitted or misstated a material fact (presumably in the process of acquiring recognition of exemption or in connection with the filing of an annual information return), operated in a manner materially different from that originally represented, or engaged in a prohibited transaction.[170] A *prohibited transaction* is a transaction entered into for the purpose of diverting a substantial part of an organization's corpus or income from its exempt purpose.[171] Thus, an organization that was recognized as an exempt charitable entity in 1947 engaged in private inurement

[163]*Tax Analysts v. Internal Revenue Service & Christian Broadcasting Network, Inc.*, 410 F.3d 715 (D.C. Cir. 2005)).

[164]5 U.S.C. § 552(b)(5). This is also known as the *deliberative process privilege*. This doctrine (first enunciated by the Supreme Court in *Hickman v. Taylor*, 329 U.S. 495 (1947)) protects documents prepared in ''contemplation of litigation'' and ''provide a working attorney with a 'zone of privacy' within which to think, plan, weigh facts and evidence, candidly evaluate a client's case, and prepare legal theories'' (*Coastal States Gas Corp. v. Dep't of Energy*, 617 F.2d 854, 864 (D.C. Cir. 1980)). This privilege does not, however, extend to every document prepared by a lawyer; protection is extended only where the document was prepared in anticipation of litigation (*Jordan v. United States Dep't of Justice*, 591 F.2d 753 (D.C. Cir. 1978)).

[165]*Trans-Pacific Policing Agreement v. United States Customs Service*, 177 F.3d 1022 (D.C. Cir. 1999)); *Judicial Watch v. United States Dep't of Justice*, 337 F. Supp. 2d 183 (D.D.C. 2004)).

[166]*Tax Analysts v. Internal Revenue Service*, 152 F. Supp. 2d 1 (D.D.C. 2001) *aff'd*, 294 F.3d 71 (D.C. Cir. 2002).

[167]*Tax Analysts v. Internal Revenue Service*, 117 F. 3d 607 (D.C. Cir. 1997).

[168]*Tax Analysts v. Internal Revenue Service*, 415 F. Supp. 2d 119 (D.D.C. 2006); *Tax Analysts v. Internal Revenue Service*, 391 F. Supp. 2d 122 (D.D.C. 2005).

[169]IRC § 7805(b)(8); Reg. § 301.7805-1(b).

[170]Reg. § 601.201(n)(6)(i).

[171]Reg. § 601.201(n)(6)(vii).

transactions[172] in that year, and had its exemption revoked in 1954, with the revocation retroactive to 1948.[173]

A fourth way in which an exemption ruling may be retroactively revoked arises when there is a change in or clarification of the pertinent law, and the tax-exempt organization was provided formal notice of the change. For example, a farmers' cooperative[174] had its exemption recognized in 1958, and had its exemption revoked in 1978, effective as of 1974, because of a law change as to which the organization was accorded notice (by publication of a revenue ruling) in 1973.[175]

In another of these instances, an organization was recognized as a tax-exempt school[176] in1959. In 1970, when the IRS's rules prohibiting exempt schools from maintaining racially discriminatory policies were introduced,[177] the agency notified the school of its concern that the school was engaging in racially discriminatory practices. The IRS commenced the process of revoking the school's exemption in 1976; this culminated in loss of the organization's exemption by court order. The IRS endeavored to revoke the school's exempt status effective as of 1959. The court upheld retroactive revocation of this exemption but only as of 1970, the year the agency expressly provided the organization with notice of the law change.[178] In a comparable case, an educational organization was recognized by the IRS as an exempt entity in 1961 and had its exemption revoked in 1977 for funding racially discriminatory schools; the revocation was made effective as of 1974, with notice given by the agency in 1972.[179]

Thus, the IRS has the discretion as to whether to revoke and organization's tax-exempt status prospectively or retroactively. This discretion is broad, reviewable by the courts only for its abuse.[180] For example, an organization that was recognized in 1936 as an exempt religious organization engaging in missionary activities faced revocation of exemption in 1976 on the ground that these activities had ceased in 1963 and were replaced by commercial publishing operations; a court concluded that the IRS did not abuse its discretion in revoking this exemption, retroactive to 1963.[181] In another case,

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[172]See App. C, II D.

[173]*Stevens Bros. Found., Inc. v. Comm'r,* 324 F.2d 633 (8th Cir. 1963), *cert. den.,* 376 U.S. 969 (1964).

[174]See *Tax-Exempt Organizations* § 19.12

[175]*West Central Coop. v. United States,* 758 F.2d 1269 (8th Cir. 1985).

[176]See App. C, ID.

[177]See *Tax-Exempt Organizations* § 6.2(b)(ii).

[178]*Prince Edward School Found. v. United States,* 478 F. Supp. 107 (D.D.C. 1979), *aff'd without pub. op.* (D.C. Cir. 1980), *cert. den*., 450 U.S. 944 (1981).

[179]*Virginia Educ. Fund. v. Comm'r,* 85 T.C. 743 (1985), *aff'd,* 799 F.2d 903 (4th Cir. 1986). Thereafter, an estate tax charitable contribution deduction was denied for a gift to this organization (*Estate of Clopton. v. Comm'r,* 93 T.C.275 (1989)).

[180]*Automobile Club of Mich. v. Comm'r,* 353 U.S. 180 (1957). Also *Dixon v. United States,* 381 U.S. 68 (1965).

[181]*Incorporated Trustees of Gospel Worker Soc'y v. United States,* 510 F. Supp. 374 (D.D.C. 1981), *aff'd*, 672 F.2d 894 (D.C. Cir. 1981), *cert. den*., 456 U.S. 944 (1982).

a religious publishing company was recognized as exempt in 1939; in 1980, the IRS proposed retroactive revocation of the exemption to 1969 on the ground that the organization started operating in a commercial manner[182] in that year. A court agreed with the IRS as to revocation of exemption but held that the agency abused its discretion in making the revocation effective as of 1969, ruling that retroactivity of the exemption should occur as of 1975.[183]

In another case on the point, a court upheld revocation in 1982 of tax exemption recognized in 1979, retroactive to 1978;[184] a court upheld revocation in 1990 of exemption recognized in 1969, retroactive to 1984;[185] a court upheld revocation in 1952 of exemption recognized in 1946, retroactive to 1946;[186] and a court upheld revocation in 1956 of exemption recognized in 1948, retroactive to 1948.[187]

In the principal case the IRS lost in this regard, the ''bounds of permissible discretion were exceeded'' by the IRS when the agency attempted to retroactively revoke, in 1951, recognition of tax exemption it issued in 1945.[188] The facts had not changed during the period involved, the organization adequately disclosed on its annual information returns the facts that prompted the attempted revocation of exemption, there were no misrepresentations of fact or fraud, and the proposed assessment of tax was ''so large as to wipe [the organization] out of existence.''[189] The court stated that it ''realize[d] that the Commissioner may change his mind when he believes he has made a mistake in a matter of fact or law.''[190] This court continued: ''But it is quite a different matter to say that having once changed his mind the Commissioner may arbitrarily and without limit have the effect of that change go back over previous years during which the taxpayer operated under the previous ruling.''[191] The court refused to sustain this proposed ''harsh result,''[192] thereby precluding this retroactive revocation of exemption.

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[182]See *Tax-Exempt Organizations* § 4.10.

[183]*Presbyterian & Reformed Publishing Co. v. Comm'r,* 79 T.C. 1070 (1982). An appellate court concluded that this organization was engaged in exempt activities, however, thereby voiding this revocation of exempt status (743 F.2d 148 (3rd Cir. 1984)).

[184]*Freedom Church of Revelation v. United States,* 588 F. Supp.693 (D.D.C. 1984).

[185]*United Cancer Council, Inc. v. Comm'r,* 109 T.C. 326 (1997), *rev'd and rem'd*, 165 F.3d 1173 (7th Cir. 1999).

[186]*Birmingham Business College, Inc. v. Comm'r,* 276 F.2d 476 (5th Cir. 1960), *aff'g, mod., and rem'g* 17 T.C.M. 816 (1958) (revocation due to material misrepresentations in the organization's application for recognition of exemption).

[187]*Cleveland Chiropractic College v. Comm'r,* 312 F.2d 203 (8th Cir. 1963), *aff'g* 21 T.C.M. 1 (1962) (consistent private inurement throughout the period).

[188]*The Lesavoy Found. v. Comm'r,* 230 F.2d 589, 594 (3rd Cir. 1956), *rev'g* 25 T.C. 924 (1956).

[189]*Id.*, 238 F.2d at 594.

[190]*Id.* at 591.

[191]*Id.*

[192]*Id.* at 594.

§ 1.13 EXPANSION OF IRS EXEMPT ORGANIZATIONS AUDIT ACTIVITY

In recent years, the IRS has greatly expanded its enforcement activity with respect to tax-exempt organizations. There are several reasons for this expansion of audit and other enforcement activity, constituting what one commentator termed the ''aggressive posture that the agency has assumed with regard to the tax-exempt sector.''[193] One of the primary reasons for this increase in enforcement effort is the predilections of then-Commissioner of Internal Revenue Mark Everson, who took a ''strong personal interest in tax enforcement since becoming Commissioner in 2003, including personally testifying at Congressional hearings, making personal appearances when tax indictments are publicly announced at press conferences, and repeated discussion of tax-exempt issues in speeches.''[194]

Other driving forces behind the increase in IRS attention to tax-exempt organizations are the following:

- *Media reports.* Media reports about exempt organizations have increased as the media are becoming more aware of the public availability of annual information and tax returns. The increasing detail being inserted in the evolving annual information return (principally Form 990 and 990-PF), such as information about related party transactions and the compensation schedules, is ensuring that this media attention does not abate. Public access to unrelated business income tax returns (Form 990-T) will also fuel media interest in exempt organizations.
- *Congressional interest.* Congress recently has shown intense interest in tax-exempt organizations. Although this is manifested most publicly in House and Senate hearings, the Senate Finance Committee staff investigations of many exempt organizations cannot be underestimated as an impact on the IRS. This intensity of interest on Capitol Hill in exempt organizations may abate somewhat, however, with the change in congressional leadership in the 110th Congress (2007–2008).
- *IRS structural changes.* The IRS has implemented a number of organizational changes designed to better access the data on annual information returns. Most notable are the Exempt Organizations Compliance Unit (which identifies issues on returns as they are filed)[195] and the Data

[193]Owens, ''Is It Safe to Go Outside?: IRS Audit Plans for Tax-Exempt Organizations,'' outline of presentation on March 2, 2006, at 78, *42nd Annual Washington Non-Profit Legal & Tax Conference* (Washington Non-Profit Tax Conference, Inc.) (''IRS Audit Plans for Tax-Exempt Organizations'').
[194]*Id*. at 79.
[195]See § 2.3(d).

Analysis Unit (which melds other databases into the annual information return database to better target the IRS's audit resources).[196]

- *IRS methodology changes.* The IRS, in a move to enhance its presence in the tax-exempt organizations universe, is now using correspondence checks and limited scope correspondence examinations (sometimes referred to as *soft contacts*) to significantly increase the number of exempt organizations with which it interacts.[197] In fiscal year 2005, for example, the IRS reported that it contacted approximately 19,700 organizations concerning a variety of compliance and education issues.[198]

In a statement concerning the IRS's fiscal year 2006 enforcement and service results, Commissioner Everson stated that the agency has ''made strong progress in a number of key enforcement categories,'' it is ''showing consistent improvements in areas critical to running a fair, efficient tax system,'' and the IRS is ''bringing in billions of dollars to the Treasury through [its] expanded enforcement activity.'' He said that the data shows a ''strong rebound in [the IRS's] enforcement efforts,'' with enforcement activity up since the restructuring of the IRS in the late 1990s[199] and ''climb[ing] significantly since I became Commissioner three-and-a-half years ago.'' Noting that ''[t]here's a strong [audit] trend line going up,'' the Commissioner observed that, in fiscal year 2006, enforcement revenues increased to a record $48.7 billion.[200]

In this statement, the Commissioner stated that the IRS audited 7,079 tax-exempt organizations' annual information returns in fiscal year 2006, an increase of 43 percent from fiscal year 2005, adding that, in this regard, the IRS is ''at the highest level since 2000.'' His statement included the following:

> In addition to increased exam activity, we introduced a new program in 2004 using non-traditional compliance contacts to expand our enforcement presence within the tax-exempt community. These compliance contacts have been instrumental in addressing problem areas in sectors such as hospitals, executive compensation and credit counseling. In Fiscal 2006, we completed over 5,200 of these new compliance contacts, over and above the traditional examination program. This is a 31% increase from the previous year. Before 2004, we weren't doing any of these contacts.

Information accompanying Commissioner Everson's statement shows an aspect of the IRS's tax-exempt organizations enforcement effort timeline, which is the number of exempt organizations' returns examined:[201]

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[196]See § 2.3(a).

[197]See § 1.6(b).

[198]The foregoing five driving forces behind current IRS exempt organizations examination activity is based on IRS Audit Plans for Tax-Exempt Organizations, at 78–79.

[199]See § 2.2, text accompanied by notes 16, 17, 24–29.

[200]''Statement of IRS Commissioner Everson on FY 2006 Enforcement and Service Results,'' November 20, 2006, reproduced at BNA, *Daily Tax Report*, November 21, 2006 (no. 224), in ''TaxCore.''

[201]A distinction should be made between an audit of a tax-exempt *organization* and an audit of an exempt organization's *return*. An audit of an exempt organization can entail more than one

FY 1997—10,700
FY 1998—10,353
FY 1999—8,611
FY 2000—7,435
FY 2001—5,342
FY 2002—5,278
FY 2003—5,754
FY 2004—5,800
FY 2005—4,953
FY 2006—7,079[202]

Commissioner Everson departed the employ of the IRS in mid-2007; Kevin M. Brown, formerly the chief operating officer of the IRS and Chief of Staff and Commissioner of the IRS Small Business/Self Employed Division, served as Acting Commissioner for several weeks thereafter. In mid-September 2007, Linda Stiff, previously the Deputy Commissioner for Operations Support, assumed the position of Acting Commissioner of Internal Revenue, Mr. Brown having resigned his employment with the IRS. Given the current political polarization in Congress, there is no immediate prospect for confirmation of the next Commissioner of Internal Revenue.

§ 1.14 CURRENT AND FUTURE FOCUS OF IRS EXEMPT ORGANIZATIONS AUDITS

It is risky—and probably futile—to predict how and where the IRS will focus its audit resources, in connection with tax-exempt organizations, in the coming years. The exempt organizations sector is under intense review by the federal government as to a wide variety of compliance issues and, as the IRS's effort to launch a sector-wide market segment study[203] illustrates, the best of plans of the IRS can be eviscerated by subsequent (unanticipated) developments. Nonetheless, recent communications from the IRS provide clues as to the current and future emphasis of the IRS's examination efforts concerning exempt organizations.[204]

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return. For example, an audit of a public charity for a tax year may involve review of a Form 990 (annual information return), Form 4720 (return reflecting payment of one or more excise taxes), and Form 990-T (unrelated business income tax return).

[202]The number for FY 2006 was said to be ''preliminary.'' In general, see ''Audits of Tax-Exempt Groups on Rise, Former IRS Official Owens Tells Forum,'' Bureau of Nat'l Affairs, *Daily Tax Report* (no. 81), April 27, 2007, at G-3.

[203]See § 4.2.

[204]This § 1.13 is based largely on the contents of a letter, dated June 28, 2007, from then-Acting Commissioner of Internal Revenue Kevin M. Brown to Senator Charles E. Grassley (''Brown Letter'') (referenced at Bureau of Nat'l Affairs, *Daily Tax Report* (no. 141), July 24, 2007, at G-7), and of prepared testimony, on July 24, 2007, presented by Steven T. Miller, Commissioner, TE/GE, before the Subcommittee on Oversight of the House Committee on Ways and Means (''Miller Testimony'') (referenced at BNA, *Daily Tax Report* (no. 142), July 25, 2007, at G-9).

The Brown Letter represents the tax-exempt sector as being ''increasingly complex,'' with some exempt entities remaining ''casual, indifferent, or even callous toward compliance,'' with others ''beginning to adopt a more structured, responsible approach.'' This letter referenced ''increased [IRS] enforcement presence'' in the area of governance. The IRS has ''reinforced the infrastructure of enforcement, which includes both the changes in the laws that have addressed abuse and an effective IRS enforcement presence.'' The Brown Letter stated that the IRS ''cannot overstate the role some professionals play in creating, promoting, and spreading tax abuse, even as others strive to prevent it.''

The Brown Letter observed that the IRS has seen a ''rise in very large exempt organizations,'' with several entities now having ''economic power that matches that of some nation-states.'' This phenomenon and the ''coming transfer of wealth between generations are driving considerable activity in financial and tax planning.'' The Miller Testimony added that many public charities are becoming ''large economic hubs,'' being ''enormous, control[ling] great wealth, and operat[ing] on a global scale.'' The Brown Letter observed that ''[w]ith size comes the ability to participate in cutting edge economic transactions, from all sorts of joint ventures to participation in private equity and hedge funds,'' and ''[f]rom the transfer of wealth comes the development of new planning devices for giving.''

The Brown Letter noted that the Internet is having an effect on the tax-exempt organizations environment, bringing issues of ''web-based fundraising and virtual charities.'' This development is ''blurring the concept and importance of state and national borders.''

The Brown Letter spoke of the ''potential misuse of charitable structures to aid terrorism.'' This threat will require the IRS to review applications for recognition of tax-exempt status and annual information returns ''against terrorist watch lists.'' The IRS ''must also be alert to other meaningful actions that would contribute to the nation's comprehensive anti-terrorism program.''

The Miller Testimony stated that the IRS maintains a ''robust examination program,'' having added staff and offices that allow the agency to ''respond flexibly to different types of non-compliance in different areas.'' The IRS, it was said, is ''constantly looking for more efficient and effective ways to conduct examinations.''

The Brown Letter identified the following key current compliance issues concerning tax-exempt organizations (which will inevitably factor into the focus of the IRS's audit program for exempt organizations):

- *Abusive tax transactions.* The IRS is ''vigilant about the use of tax-exempt entities to accommodate, promote, or otherwise serve a role in abusive tax transactions.''[205]

[205]See *Tax-Exempt Organizations* § 27.15.

- *Charitable contribution overvaluation.* The IRS expects that ''overvaluation will continue to be a significant problem in charitable contributions of property,'' with these overvaluations arising from ''taxpayer or appraiser error, from deliberate abuse, or from aggressive taxpayer or appraiser positions.''[206]
- *Charitable family limited partnerships.* The IRS is continuing to track use of charitable family limited partnerships, typically involving ''large, questionable charitable contribution deductions and the sheltering of appreciation in a tax-exempt entity.''[207]
- *Conservation easements.* Valuation is the ''key issue'' the IRS is seeing in connection with charitable gifts of conservation easements, with other issues being the retention or creation of rights in the donors, easements not granted in perpetuity, a donee's lack of resources to enforce the easements, and various problems with historic easements, particularly façade easements.[208]
- *Underreporting.* The IRS is discovering that it is receiving ''imperfect'' data on annual information returns, leading to an ''absence of transparency.''
- *Charities established to benefit the donor.* The IRS is continuing to focus on the establishment and use of donor-advised funds[209] and supporting organizations.[210]
- *Charitable trusts.* The IRS continues to examine a variety of transactions, involving purported charitable or split-interest trusts, that allow individuals to ''deduct amounts as charitable contributions that ultimately they will use for personal expenses.''
- *Commercial operators.* The IRS sees the ''movement of commercial enterprise into the charitable sector'' as an issue, with abuses being found in connection with hospitals,[211] credit unions,[212] credit counseling organizations,[213] down payment assistance organizations,[214] and nursing homes.
- *Unrelated business income determinations.* The IRS is coping with problems concerning the distinctions between related and unrelated activities, and

[206]See *Charitable Giving* §§ 10.1, 10.14, 21.2.
[207]See *id*. § 9.24.
[208]See, e.g., *id*. § 9.7.
[209]See *Tax-Exempt Organizations* § 11.8.
[210]See *id*. § 12.3(c); *Private Foundations* § 15.7.
[211]See *Tax-Exempt Organizations* § 7.6(a).
[212]See *id*. § 19.7.
[213]See *id*. § 7.3.
[214]See *id*. § 7.5.

the allocation of income and expenses between related and unrelated economic activity.[215]

- *Executive compensation.* The IRS continues to examine situations involving ''high'' or ''excessive'' compensation, with implications as to application of the doctrine of private inurement[216] and the intermediate sanctions rules.[217]
- *Political campaign activities.* The IRS is continuing its extensive examination of the involvement of churches and other public charities in political campaign activities.[218]
- *Political organizations.* The IRS is likewise continuing its examination of the activities and reporting compliance by political organizations.[219]

The Brown Letter concluded by exploring these four questions:

1. Have changes in practice or industry created gaps in the statutory or regulatory framework?
2. Does the IRS have the flexibility to respond appropriately to compliance issues?
3. Should more be done to promote transparency, good governance, and efficient delivery of public benefits?
4. Does the IRS have the resources it needs to do the job?

By means of the Miller Testimony, the IRS stated that, ''[w]hile we have found some tax compliance problems in the charitable sector, we remain quite optimistic that through our efforts and the efforts of others, these problems have not reached and will not reach the core of the charitable sector.'' The IRS stated that it ''remain[s] aware of the need for a balanced program in regulating this sector, a sector that does vital work for our society.'' The agency added that it ''intend[s] to keep pace with this vibrant sector as it continues to evolve and change,'' and that it ''will work to ensure that the public remains confident that its contributions of time, effort, and money, and the tax subsidies Congress provides to the charitable sector, are used well for the benefit of the public.''[220]

The Brown Letter stated that, ''while service and enforcement remains our mission, our compliance strategy must evolve to keep pace with the changing compliance environment.'' It was noted that the IRS is launching a study of reporting compliance by the tax-exempt sector, staff is being added to

[215]See *Tax-Exempt Organizations* § 24.14; *Unrelated Business* § 11.2.
[216]See *Tax-Exempt Organizations*, Chapter 20.
[217]See *id.*, Chapter 21. Also see § 4.2.
[218]See *Tax-Exempt Organizations*, Chapter 23. Also see § 4.3.
[219]See *Tax-Exempt Organizations*, Chapter 17.
[220]As to this matter of tax subsidies, see *Tax-Exempt Organizations* § 1.4.

strengthen the IRS's examinations and determinations programs, and the EO Compliance Unit is being expanded. Clearly, the foregoing provides ample guidance as to the contours of the IRS's audit activity in connection with tax-exempt organizations, with deviations only in the event of unexpected developments.[221]

[221] Immediately following release of the Brown Letter, Sen. Grassley said in a statement that the letter is ''sober reading for anyone who supports the charitable sector'' and that ''[b]ig problems remain across the board'' (Bureau of Nat'l Affairs, *Daily Tax Report* (no. 141), July 24, 2007, at G-7.

CHAPTER TWO

Organization of the IRS

Among the departments of the government of the United States is the Department of the Treasury, which is headed by the Secretary of the Treasury. The Internal Revenue Service is a component of the Treasury Department.

§ 2.1 STRUCTURE OF DEPARTMENT OF TREASURY

One of the functions of the Treasury Department[1] is assessment and collection of federal income and other taxes.[2] The Secretary is authorized to

[1]The Department of the Treasury was created by an act of Congress dated September 2, 1789 (31 U.S.C. § 301). Today, the authority for the Department of the Treasury is in IRC § 7801(a)(1), although, read literally, that law authorizes the Secretary of the Treasury.

[2]IRC § 7601(a), which provides that the Secretary of the Treasury ''shall, to the extent he deems it practicable, cause officers or employees of the Treasury Department to proceed, from time to time, through each internal revenue district [authorized by IRC § 7621] and inquire after

conduct examinations,[3] serve summonses,[4] and otherwise undertake what is necessary for ''detecting and bringing to trial and punishment persons guilty of violating the internal revenue laws or conniving at the same.''[5] This tax assessment and collection function has largely been assigned to the IRS, which is an agency (or bureau) of the Department of the Treasury.[6]

(a) Treasury Department in General

A Deputy Secretary and an Under Secretary for Domestic Finance, *inter alia*, assist the Secretary of the Treasury. The Department of the Treasury formulates the nation's tax policies, including those pertaining to tax-exempt organizations.[7] This policy formulation is the direct responsibility of Treasury's Assistant Secretary (Tax Policy). Positions within the Tax Policy office include the Tax Legislative Counsel and the Deputy Assistant Secretary for Tax Policy.

Within the Treasury Department is the Office of General Counsel for the Department of the Treasury.[8] This general counsel, who is appointed by the President, is the chief law officer of the Department. Among the associate chief counsels is the Associate Chief Counsel (Employee Benefits and Exempt Organizations). One of the functions of this Associate Chief Counsel's office is to develop policy and strategy in the field of the law of tax-exempt organizations.

Also within the Department of the Treasury (and at the same level as the Assistant Secretary (Tax Policy) and the General Counsel) is the Treasury Inspector General for Tax Administration and the Assistant Secretary (Legislative Affairs and Public Liaison).

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and concerning all persons therein who may be liable to pay any internal revenue tax, and all persons owning or having the care and management of any objects with respect to which any tax is imposed.''

[3]IRC § 7602.

[4]IRC § 7603. See § 1.8.

[5]IRC § 7623.

[6]Reg. § 601.101(a). The federal agency created (in 1862) to collect taxes was named the Bureau of Internal Revenue. The name was changed in 1953 to the Internal Revenue Service (Treasury Decision 6038, 1953-2 C.B. 443) to emphasize the ''service'' element of the agency's efforts on behalf of taxpayers.

There are arguments that, because there is no statutory authority for the IRS (in connection with the Treasury Department or otherwise), the agency is thus illegitimate. (Oddly, while the IRS is not authorized by statute, the Office of the Commissioner of Internal Revenue is; see *infra* note 16.) One of the better summaries of the IRS of this genre has it that the IRS ''appears to be a collection agency working for foreign banks and operating out of Puerto Rico under color of the Federal Alcohol Administration'' (Mitchell, ''31 Questions and Answers about the Internal Revenue Service,'' at www.supremelaw.org/sls/31answers.htm).

The IRS, not surprisingly, sees the matter differently. The agency asserts that it is organized to carry out the responsibilities of the Secretary of the Treasury under IRC § 7801 (see *supra* note 1). The Treasury Secretary has full authority to administer and enforce the internal revenue laws and has the power to create an agency to enforce these laws; the IRS ''was created based on this legislative grant'' (IRM 1.1.1.2 § 1).

[7]IRC § 7801(a)(1).

[8]IRC § 7801(b)(1).

(b) Treasury Inspector General for Tax Administration

Within the Department of the Treasury is the Office of Treasury Inspector General for Tax Administration (TIGTA).[9] TIGTA is authorized to ''exercise all duties and responsibilities of an Inspector General of an establishment with respect to the Department of the Treasury and the Secretary of the Treasury on all matters relating to the Internal Revenue Service,'' and has ''sole authority'' to ''conduct an audit or investigation of the Internal Revenue Service Oversight Board and the Chief Counsel for the Internal Revenue Service.''[10]

TIGTA, which consists mainly of auditors and investigators, was established in January 1999 to provide independent oversight of IRS activities. TIGTA is organizationally placed within the Department of the Treasury but is independent of the Treasury offices, including the Treasury Office of the Inspector General (OIG). TIGTA's focus is devoted entirely to tax administration; Treasury OIG is responsible for overseeing the other Treasury bureaus.[11]

TIGTA's focus is devoted to all aspects of work related to federal tax administration. Its audit and investigative activities consist of promotion of economy, efficiency, and effectiveness in administering the nation's tax system; detection and deterrence of fraud and abuse in IRS operations; protection of the IRS against external attempts to corrupt or threaten its employees; review and the making of recommendations about existing and proposed legislation and regulations related to IRS and TIGTA operations; prevention of fraud, abuse, and deficiencies in IRS programs and operations; and informing the Department of the Treasury and Congress of problems and progress made to resolve them. TIGTA states that it is committed to serving the needs of the public by conducting audits and other investigations that improve IRS operations.[12]

§ 2.2 IRS IN GENERAL

The principal purpose of the IRS is to enforce the internal (U.S.) revenue laws and collect taxes. The agency states that its mission is to ''provide America's taxpayers with top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.''[13] An expert on the subject states the matter this way: ''The specific role of the Internal Revenue Service in the [federal tax] system is to both collect and protect the revenue without incidentally frustrating or

[9]TIGTA was created on enactment of the Internal Revenue Service Restructuring and Reform Act of 1998 § 1103(a), amending § 2 of the Inspector General Act of 1978 (5 U.S.C. App.).
[10]Inspector General Act of 1978, *supra* note 9 § 8D(h).
[11]TIGTA web site (www.tigta.gov).
[12]*Id*.
[13]This mission statement is on the IRS web site and is reproduced each week in the Internal Revenue Bulletin (I.R.B.). It also appears in the IRM 1.1.1.1.

terrorizing the taxpayer population.''[14] The IRS noted that Congress creates the tax laws; the taxpayer's role is to understand and meet his, her, or its tax obligations; and the function of the IRS is to ''help the large majority of compliant taxpayers with the tax law, while ensuring that the minority who are unwilling to comply pay their fair share.''[15]

One of the functions of this agency is to administer and enforce the law of tax-exempt organizations. The mission and functions of the IRS have been substantially influenced by a massive restructuring of the agency, due in part to the mandates of legislation[16] and in part to initiatives undertaken by the agency as the result of a plan of reorganization that was implemented in 1998.[17]

The IRS is headquartered in Washington, D.C.; its operations there are housed principally in its National Office.[18] An Internal Revenue Service Oversight Board is responsible for overseeing the agency in its administration, conduct, direction, and supervision of the execution and application of the nation's internal revenue laws.[19] A function of this board is to recommend to the President candidates for the position of Commissioner of Internal Revenue, who is the executive of the IRS.[20] The Commissioner, who need not be a tax lawyer or an accountant but must have a ''demonstrated ability in management,'' serves one or more five-year terms.[21] The Commissioner is charged with administering, managing, conducting, directing, and supervising the execution and application of the internal revenue laws.[22] The Commissioner is assisted by two Deputy Commissioners, one for Services and Enforcement, the other for Operations Support.

Congress in 1998 directed the Commissioner of Internal Revenue to reorganize the IRS in a way that substantially altered the then-existing structure (which was based on regional divisions) by restructuring the agency into units

[14]David, *Dealing with the IRS: Law, Forms, and Practice* (American Law Institute/American Bar Association, 2001) (*Dealing with the IRS*) at 7.
[15]IRM 1.1.1.1 § 2.
[16]Internal Revenue Service Restructuring and Reform Act of 1998, 105th Cong., 2nd Sess. (1998), 112 Stat. 685 (Pub. L. No. 105-206) (for purposes of this section, *Act*).
[17]See *infra* note 24.
[18]The IRS's general operations are located at 1111 Constitution Avenue, N.W., Washington, D.C. 20224; the Exempt Organizations Division's offices are located in the 1750 Penn Building, N.W., Washington, D.C.
[19]IRC § 7802(a), (c)(1)(A).
[20]IRC § 7802(d)(3)(A). When the predecessor to the IRS was created in 1862 (see *supra* note 5), the head of the agency was named the Commissioner of Internal Revenue. The Office of the Commissioner of Internal Revenue was established by act of Congress dated July 1, 1862 (26 U.S.C. § 7802).
[21]IRC § 7803(a)(1).
[22]IRC § 7803(a)(2)(A). Also Reg. § 601.101(a) (providing that the Commissioner has ''general superintendence of the assessment and collection of all taxes imposed by any law providing national revenue'').

serving groups of taxpayers[23] with similar needs.[24] Consequently, the IRS is organized into four operating divisions; the structure is reflected in the IRS's regional offices. These divisions are the Tax Exempt and Government Entities (TE/GE) Division (the first to begin operations[25]),[26] the Large and Mid-Size Business Division,[27] the Small Business/Self-Employed Division,[28] and the Wage and Investment Division.[29]

These four divisions, each headed by a commissioner, report to the Deputy Commissioner, Services and Enforcement. Also under the auspices of this Deputy Commissioner are the Criminal Investigation component[30] and the Office of Professional Responsibility.[31] The functions of the IRS that report to the Deputy Commissioner, Operations Support are the Offices of the Chief Financial Officer and the Chief Information Officer, and the Office of Business Systems Modernization.

Within the IRS is the Office of the Chief Counsel; the Chief Counsel is appointed by the President and confirmed by the U.S. Senate. The Chief Counsel is the principal legal advisor to the Commissioner of Internal Revenue; the mission of this office is to ''[s]erve America's taxpayers fairly and with integrity by providing correct and impartial interpretation of the internal revenue laws and the highest quality legal advice and representation for the Internal Revenue Service.''[32]

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[23] A *taxpayer* is a person subject to any internal revenue tax (IRC § 7701(a)(14)); this term includes a tax-exempt organization. See § 1.9, n. 79.

[24] Act § 1001(a)(3). This approach was a reinforcement of a plan announced by the Commissioner of Internal Revenue on January 28, 1998. The IRS, on its web site, states: ''The IRS reorganized itself to closely resemble the private sector model of organizing around customers with similar needs.'' The agency wrote that these four divisions are responsible for the ''major customer segments'' (IRM 1.1.1.3 § 1). A history of this reorganization and its transition is in *Dealing with the IRS* 9–11, 509–521. A history of the organization of the IRS in general is available in IRM 1.1.2.

[25] McGovern, ''The Tax Exempt and Government Entities Division: The Pathfinder,'' 27 *Exempt Org. Tax Rev.* (no. 2), 239 (Feb. 2000).

[26] See § 2.3.

[27] This division serves corporations with assets in excess of $10 million (IRM 1.1.1.3 § 1).

[28] This division serves approximately 45 million small business/self-employed filers (*id.*).

[29] This division serves approximately 120 million taxpayers with wage and investment income only (*id.*).

[30] The criminal investigation component of the IRS ''serves the American public by investigating potential criminal violations of the Internal Revenue Code and related financial crimes in a manner that fosters confidence in the tax system and compliance with the law'' (IRS web site; IRM 1.1.1.3 § 2 C).

[31] This office administers the laws governing the practice of tax professionals before the Department of the Treasury, including the IRS (IRM 1.1.1.3 § 2L).

[32] IRS web site. The Office of Chief Counsel ''[p]rovides legal interpretation and represents the IRS with complete impartiality, so that taxpayers know the law is being applied with integrity and fairness'' (IRM 1.1.1.3 § 2 M). The Chief Counsel reports to the Commissioner of Internal Revenue on tax matters and reports to the Treasury General Counsel on other matters.

Still other components of the IRS are the Appeals function[33] and the office of the National Taxpayer Advocate,[34] both of which report directly to the Commissioner of Internal Revenue. Also reporting directly to the Commissioner are the divisions or offices of Research, Analysis and Statistics;[35] Communications and Liaison;[36] Equal Employment Opportunity and Diversity;[37] and Mission Assurance and Security Services.[38] In addition, there is a Chief Financial Office[39] and a Chief Information Office.[40] The Commissioner is assisted by an Assistant to the Commissioner, a Special Assistant to the Commissioner, an Attorney-Advisor, a Program Advisor, Executive Secretariat, a Chief of Staff, and two staffers.

There are eight service centers, located in Andover, Massachusetts; Atlanta, Georgia; Holtsville, New York (Brookhaven); Fresno, California; Kansas City, Missouri; Memphis, Tennessee; Ogden, Utah; and Philadelphia, Pennsylvania. The IRS's organizational structure includes five Exempt Organizations Area Managers, for the Great Lakes, Gulf Coast, Mid-Atlantic, Northeast, and Pacific Coast.

The IRS has organized the nation into 16 areas with approximately 86 territories.[41] Most examination contact with taxpayers is made by means of correspondence from service center (sometimes termed *campuses*) tax examiners. Territory offices have both tax auditors and revenue agents assigned to them who, in groups of about 10, report to a group manager. The group manager reports to a territory manager who is in charge of four or five groups of agents. The territory manager reports to an area manager.[42]

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[33]See § 2.6.

[34]See § 2.7.

[35]This division provides ''strategic Servicewide research, analysis, studies, and support to internal and external stakeholders'' (IRM 1.1.1.3 § 2K).

[36]This office provides ''IRS employees, [and] legislative, executive, state, business, and professional stakeholders with a better understanding of the IRS mission and goals'' (IRM 1.1.1.3 § 2D).

[37]This office provides ''strategic planning, management, direction, and execution of the full range of activities related to the EEO and Diversity function'' (IRM 1.1.1.3 § 2H).

[38]This office assists ''all IRS Divisions and Functions in maintaining secure facilities, technology, and data'' (IRM 1.1.1.3 § 2 J).

[39]This office ''[m]anages a portfolio of corporate-wide activities including strategic planning, performance measurement, budget formulation, budget execution, accounting, financial management, and internal controls'' (IRM 1.1.1.3 § 2F).

[40]This office ''[m]anages Servicewide information resources and technology management and the Service's long-range objectives and strategies for improving tax administration through modernizing tax administration systems'' (IRM 1.1.1.3 § 2I).

[41]The IRS previously maintained key district offices where applications for recognition of exemption were filed, but these offices no longer exist (Rev. Proc. 2007-52, 2007-30 I.R.B. 222 § 2.01(1)).

[42]This paragraph is based on a paragraph in *Dealing with the IRS*, 2006-07, Cumulative Supplement (*Dealing with the IRS Supplement*) at 3.

§ 2.3 TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

The TE/GE Division was established on December 5, 1999, as part of the IRS's modernization effort.[43] The mission of the Division is to ''provide TE/GE customers top quality service by helping them understand and comply with applicable tax laws and to protect the public interest by applying the tax law with integrity and fairness to all.''[44] TE/GE customers are tax-exempt organizations, employee plans, and government entities.[45]

(a) Overall Organization

The TE/GE Division is headed by a Commissioner (TE/GE), assisted by a Deputy Commissioner. The Commissioner (TE/GE), who reports to the Commissioner of Internal Revenue,[46] is ''responsible for the uniform interpretation and application of the Federal tax laws on matters pertaining to the Division's customer base.'' Also, the Commissioner ''provides advice and assistance throughout the Service, to the Department of the Treasury, [and] other government agencies, including state governments and Congressional committees.''[47] He or she is ''responsible for planning, managing, directing and executing nationwide activities for Employee Plans, Exempt Organizations, Government Entities (including Indian Tribal Governments, Federal, State and Local Governments, and Tax Exempt Bond issuances) and Customer Account Services.''[48] The Commissioner (TE/GE) is assisted by an executive assistant, an executive assistant (technical), a senior technical advisor, a technical advisor, two staff assistants, and a secretary.

Within the TE/GE Division is the Exempt Organizations Division, which develops policy concerning and administers the law of tax-exempt organizations. The Director of the Exempt Organizations Division, who reports to the Commissioner, TE/GE , is responsible for planning, managing, and executing nationwide IRS activities in the realm of exempt organizations. This director also supervises and is responsible for the programs of the offices of Customer Education and Outreach, Rulings and Agreements, Exempt Organizations Electronics Initiatives, and Examinations.[49] The director is assisted by two executive assistants and a secretary.

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[43]IR-1999-101. In general, Boisture, Davis & Mayer, ''How the IRS Plans to Restructure Its Exempt Organizations Operations,'' 10 *J. Tax Exempt Orgs*. (no. 5) 195 (Mar./Apr. 1998).
[44]IRM 1.1.23.1 § 1.
[45]IRM 1.1.1.3 § 1.
[46]IRM 1.1.23.2 § 1.
[47]IRS web site.
[48]IRM 1.1.23.2 § 2. The role of the Commissioner and Deputy Commissioner, in relation to the matter of issue elevation (see § 3.8), is the subject of IRM 1.54.1.6.6.
[49]The role of this Director, in relation to the matter of issue elevation, is the subject of IRM 1.54.1.6.5.

The Customer Education and Outreach office, headed by a Group Manager, develops the nationwide education and outreach programs of the IRS for tax-exempt organizations. Revenue agents, tax law specialists, and other personnel staff this office, initiating and delivering programs and products designed to assist exempt organizations understand their tax law responsibilities. These programs are intended to improve compliance with the federal tax law by exempt organizations. This office's efforts result in workshops and other presentations by the IRS, publications and forms, web-based programs, marketing and other communications programs, and support for programs of the Examinations office.[50]

The Rulings and Agreements office, headed by a Director, plans, manages, and executes nationwide activities for the IRS's tax-exempt organizations determinations and technical guidance programs. The Exempt Organizations (EO) Determinations component of this office considers whether organizations meet the requirements for recognition as exempt entities under the federal tax law.[51] The IRS states that the term *EO Determinations* means the office of the agency that is ''primarily responsible for processing initial applications [for recognition of] tax-exempt status,'' noting that the term includes the ''main EO Determinations office located in Cincinnati, Ohio, and other field offices that are under the direction and control of the Manager, EO Determinations.''[52]

A Technical Guidance and Quality Assurance office, headed by a Group Manager, promotes fair, impartial, courteous, and professional processing of determinations cases. Exempt Organizations Technical, headed by a Manager, processes applications for recognition of exemption referred from the Determinations unit, responds to technical advice and other assistance requests from the Examinations office, and issues private letter rulings. Exempt Organization Technical Guidance and Quality Assurance provides technical interpretations of laws and procedures relating to exempt organizations, in conjunction with the Department of the Treasury and the Office of Chief Counsel. The IRS states that the term *EO Technical* means the office of the agency, located in Washington, D.C., that is ''primarily responsible for issuing letter rulings to taxpayers on exempt organization matters, and for providing technical advice or technical assistance to other offices of the [IRS] on exempt organization matters.''[53]

TE/GE Directors are responsible for the types of issues as illustrated by the following:

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[50]See § 2.4.
[51]See *Tax-Exempt Organizations* §§ 3.2, 25.1.
[52]Rev. Proc. 2007-52, 2007-30 I.R.B. 222 § 1.01(3).
[53]*Id*. § 1.01(4).

- Issues of ''national concern''
- Issues the resolution of which is vested in a director by statute, regulation, revenue procedure, functional statement, delegation order, other directive, or established practice
- Issues relating to the revocation of a closing agreement[54] or a compliance statement
- Issues involving requests for relief in relation to retroactive revocations[55]
- Issues involving refunds to taxpayers of $1 million or more, which must be reported to the Joint Committee on Taxation[56]
- Issues affecting an entire category of taxpayers
- Issues relating to ''significant errors'' by TE/GE or errors with ''national impact''
- Issues having a ''significant or enduring impact'' on customer service within a locality, an area, or throughout the country
- Matters reported to TIGTA[57]
- Disputes with other federal agencies
- Issues that are ''newsworthy within one or more areas, or nationally''
- Issues involving a ''large number of taxpayers, a large amount of money, or a well known entity or organization''
- Issues relating to investigations by the Government Accounting Office or TIGTA[58]

Senior managers in the TE/GE structure include Area Managers; Manager, EO Determinations; Manager, EO Determination Quality Assurance; Manager, EO Technical; Manager, EO Technical Quality Assurance; Manager, EO Projects/Voluntary Compliance; and EO Examinations.[59] The function of these individuals within TE/GE is reflected in the matter of issue elevation,[60] inasmuch as they constitute the first level of management to which issues are formally elevated. Issues of national concern, once elevated to senior managers, are usually thereafter elevated to a national director or to the Commissioner or Deputy Commissioner, TE/GE.[61]

[54]See § 1.10.
[55]IRC § 7805(b). See § 1.12.
[56]See § 5.2(d).
[57]See § 2.1(b).
[58]IRM 1.54.1.6.4 § 2.
[59]IRM 1.54.1.6.3 § 2.
[60]See § 3.8.
[61]IRM 1.54.1.6.3 § 1.

Issues that are to be elevated to TE/GE senior managers include the following:

- Issues the resolution of which has been delegated to managers and directors by delegation order, directive, or practice
- Issues that are ''novel or unprecedented''
- Issues that are ''newsworthy''
- Issues having an impact on customer service
- Complaints against employees or managers
- Issues relating to errors by TE/GE
- Issues relating to resources necessary to carry out the TE/GE mission[62]

Also within the Exempt Organizations Division are Technical Group 1, Technical Group 2, Technical Group 3, and Technical Group 4, each of which is headed by a Manager. There are two Exempt Organizations branches, each headed by a Branch Chief. Branch 1 consists of an assistant branch chief, a senior technical reviewer, six attorneys, and a secretary. Branch 2 consists of an assistant branch chief, a senior technical reviewer, two senior counsels, four attorneys, and a secretary.

The Electronic Initiatives office manages and coordinates the development and deployment of new automation efforts to support evolving and expanding IRS administration and enforcement expectations, with the objective of balancing customer satisfaction, employee satisfaction, and business results. The projects of this office include implementation of the agency's annual information returns electronic filing program,[63] development of an interactive web-based application for recognition of exemption to be filed by charitable organizations,[64] and support of the operations of the Data Analysis Unit.

Group managers within TE/GE have the initial responsibility to see that appropriate issues are elevated[65] to the correct level. They are responsible for ensuring that matters within their group or branch, that must be elevated (in accordance with a statute, revenue procedure, field directive, or the like), are identified and properly elevated.[66] TE/GE employees in general (what the IRS terms *front-line employees*) are expected to work closely with their group managers, communicating regularly and frequently with them, keeping the managers informed of the progress of their work, of unusual issues that present themselves, and of any problems they encounter in resolving or concluding

[62]IRM 1.54.1.6.3 § 3.
[63]See *Tax-Exempt Organizations* § 27.4.
[64]*Id*. § 25.2(a).
[65]See § 3.8.
[66]IRM 1.54.1.6.2.

their work. These employees are to notify their group managers of ''matters that are beyond their training or competence, of procedures that work well or do not work well, and of the reaction of taxpayers to the manner in which TE/GE is serving them.'' The matter of formal issue elevation is thus not ordinarily present in these relationships, although issue elevation in this setting can occur informally.[67]

Another consequence of the reorganization of the IRS is the centralization of certain tax-exempt organizations functions. Applications for recognition of exemption are generally sent to the IRS service center in Cincinnati, Ohio; annual information returns are filed with the IRS service center in Ogden, Utah. The IRS annually issues Exempt Organizations Implementing Guidelines, which commenced with those issued during the federal government's fiscal year 2001;[68] these documents summarize how the TE/GE Division is applying its resources in support of the agency's major strategies and priorities in the exempt organizations area.[69]

The strategic priorities of the TE/GE Division (which are aligned with the strategic goals of the IRS overall) are as follows:

- Strengthen enforcement activities.
- Advance the public interest.
- Enable a paperless environment.
- Promote self-guidance, self-assistance, and self-correction.
- Enhance customer satisfaction.
- Foster proactive partnerships.
- Employ a highly qualified, diverse, and motivated workforce.[70]

(b) Customer Profile

The estimated three million ''customers'' of this Division ''range from small local community organizations and municipalities to major universities, huge pension funds, state governments, Indian tribal governments and participants of complex tax exempt bond transactions.'' This sector—generally the nonprofit sector—controls approximately $8.2 trillion in assets and pays over $220 billion in employment taxes and income tax withholding. Tax-exempt

[67]IRM 1.54.1.6.1.

[68]Each set of these implementing guidelines is summarized in *Bruce R. Hopkins' Nonprofit Counsel*. For example, the most recent of these guidelines, for the federal government's fiscal year 2007, are summarized in the January 2007 issue.

[69]The foregoing summary of the functions of the IRS offices within the TE/GE Division is based in part on information provided in the IRS's Exempt Organizations Implementing Guidelines for the government's fiscal year 2004.

[70]IRS web site.

organizations represent more than 1.6 million entities with about $2.4 trillion in assets. Governed by ''complex, highly specialized provisions of the tax law,'' this ''customer segment'' of the Division ''is not designed to generate revenue''; rather, the responsibility of the Division is to ''ensure that the entities fulfill the policy goals that their tax exemption was designed to achieve.''[71]

(c) Operations

To accomplish its mission, the TE/GE Division:

- Develops and implements TE/GE measures that balance customer satisfaction, employee satisfaction, and business results
- Assists TE/GE customers in understanding their tax responsibilities by providing information through plain-language publications, seminars and workshops, web sites, and other products
- Regulates and monitors tax-exempt organizations through examination of returns, with emphasis on assuring that exempt organizations continue to meet the statutory requirements for exemption and their other federal tax law responsibilities
- Contracts with service centers and other internal or external entities for the processing of TE/GE customer returns and payments, directly or, where appropriate, through agency-wide shared services
- Provides basic procedures and rules for uniform interpretation and application of federal tax and related laws applicable to tax-exempt organizations
- Conducts examination programs and coordinates a delinquent returns program involving tax-exempt organizations
- Conducts an ongoing research program to gather data relative to the TE/GE universe in order to direct compliance activities to areas of actual or suspected noncompliance
- Provides advice, assistance, and coordination throughout the IRS, with other federal and state governmental agencies, and congressional committees, regarding the operations or performance of TE/GE, and on legislative, regulation, litigation, and Freedom of Information Act matters and requests for inspection of application files
- Prescribes the extent to which rulings issued by or pursuant to authorization from the TE/GE Commissioner shall be applied without retroactive effect; provides appropriate authorization for church tax

[71] *Id.*

inquiries and examinations;[72] approves and enters into closing agreements;[73] and may grant a reasonable extension of the time fixed by regulation for making elections or applications from relief from tax

- Abates certain IRC Chapter 42 and 43 excise taxes[74]
- Participates in equal employment and diversity program activities[75]

The TE/GE Division is also responsible for providing interpretations of laws and procedures by publishing revenue rulings and revenue procedures, and providing pre-transactional rulings to specific requestors and issuing technical advice[76] and technical assistance to IRS personnel regarding tax-exempt organizations.[77]

One of the consequences of the reorganization of the IRS and the creation of the TE/GE structure[78] was creation of new patterns for the reporting of information and for decision-making. Thus, a key feature of this reorganization was the ''restructuring of lines of authority.''[79] All TE/GE employees, irrespective of where they are ''physically located, report through a chain of command that begins with immediate supervisors, includes Area Managers, or their equivalent, and National Directors, and goes ultimately to the Commissioner, TE/GE.'' Otherwise stated, ''everyone within TE/GE is part of a single, unified organization, and the lines of authority within it run from the Commissioner, TE/GE downward to every individual.''[80]

It is the view of the IRS that, for the TE/GE component of the agency to ''function well, certain types of information and certain decisions must be elevated from working levels of the organization to [the] managerial and executive levels.''[81] The current TE/GE structure ''means that it is now appropriate, and sometimes essential, for higher ranking managers and executives to involve themselves directly in the direction and decision of cases being worked on or considered at a lower level. In some instances, managers and executives will involve themselves in cases to apply their experience and judgment at an

[72]See §§ 6.6, 6.7.
[73]See § 1.10.
[74]See App. C §§ II F, III A, IV A.
[75]IRM 1.1.23.2 § 3.
[76]See § 1.9.
[77]IRM 1.1.23.2 § 4.
[78]See text accompanied by *supra* notes 16, 17, 24–29.
[79]IRM 1.54.1.1 § 1.
[80]*Id*. § 1B. Previously, employees, including managers, of the Office of Employee Plans/Exempt Organizations who worked outside of the National Office reported to local District Directors, rather than to the Assistant Commissioner (EP/EO); under this arrangement, the Assistant Commissioner (EP/EO) did not have direct authority over the work performed by most EP/EO employees, nor did the Directors of the Exempt Organizations (and Employee Plans) Divisions (*id*. § 1A).
[81]*Id*. § 2A.

early stage in the development of the case. In other instances, they will involve themselves as observers, in order to educate themselves about the manner in which work is performed in the field.''[82]

TE/GE employees are expected to understand that ''involvement in cases or issues by senior managers and executives is appropriate, is undertaken for good reasons, and does not suggest or imply criticism of how work is being performed at lower levels.'' These employees ''should also understand that such managerial or executive involvement is required for the sound management of a complex organization such as TE/GE, and does not reflect political influence, or other inappropriate meddling in cases.''[83] The potential of this involvement of managers and executives in a case involving a tax-exempt organization is of interest to and has consequences for the organization and its advisors. This policy has spawned the practice of *issue elevation*.[84]

(d) Enforcement Function

Congress has established in the tax law certain limitations on what organizations that have been granted the privilege of tax exemption may do.[85] Tax exemption is accorded only for certain defined categories of activity. Those who wish exemption from income tax must act within those limitations. This is the cost of tax exemption—the conditions that must be met to receive the benefits of tax exemption.

The IRS has a balanced program for regulating the charitable sector. Within the IRS, TE/GE has the responsibility to administer and enforce these limits. Doing so accomplishes a number of important public purposes. First, it ensures that congressional intent is honored. Second, it helps maintain public confidence in the integrity of the charitable sector. Third, it prevents the erosion of the tax base by ensuring that those who would prey on innocent contributors or misuse the privilege of tax-exempt status are identified and stopped from doing so.

The IRS approaches this responsibility with a balanced program that emphasizes both service and enforcement. The 860 members of TE/GE's Exempt Organizations function carry out this program. TE/GE's efforts in this area may be best described as falling into three categories: determinations or rulings on prospective matters, education and outreach, and a vigilant examination program.

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[82] *Id*. § 2B.
[83] *Id*. § 3.
[84] See § 3.8.
[85] This § 2.3(d) is based, nearly verbatim, on selected paragraphs from the prepared text of testimony provided by Steven T. Miller, Commissioner (TE/GE), IRS, before the Oversight Subcommittee of the House Ways and Means Committee, on the subject of the oversight of tax-exempt organizations, on July 24, 2007 (reproduced at Bureau of Nat'l Affairs, Inc., *Daily Tax Report* (no. 142) G-9 (July 25, 2007)).

While the IRS provides an upfront evaluation of a charity's exempt status and supports exempt organizations with customer education and outreach, the agency must also have a process to review these organizations as they operate. The IRS thus maintains a robust examination program. The agency has made major changes in the way it examines organizations in the last few years, adding staff and offices that allow it to respond flexibly to different types of noncompliance in different areas. The IRS is constantly looking for more efficient and effective ways to conduct examinations.

The IRS's examination program is aimed at detecting and deterring noncompliant behavior. The agency has strengthened this program in a number of ways over the past several years, including shifting resources into it. In fiscal year 2003, the IRS had 394 full-time examination employees and performed 5,754 examinations. By fiscal year 2006, it increased full-time examination employees to 507 and examined 7,079 returns—an increase of 23 percent from 2003 and the highest level since fiscal year 2000. In addition, the IRS has created new offices and engineered new business processes that broaden and strengthen its compliance presence. These include the Exempt Organization Compliance Unit (EOCU), the Data Analysis Unit (DAU), and the Exempt Organization Financial Investigations Unit (FIU).

§ 2.4 HEADQUARTERS MISSION

The IRS's TE/GE Headquarters consists of the Office of the TE/GE Commissioner and Deputy Commissioner, along with the directors and staff of the following units: Senior Technical Advisor, Finance, Planning, Human Resources, Communications and Liaison, Business Systems Planning, Research and Analysis, EEO and Diversity, and Administrative Services.[86]

The mission of TE/GE Headquarters is to support the TE/GE Commissioner by providing ''strategic and operational support for the operating units within'' the Exempt Organizations Division.[87] This office will also ''interpret, modify as appropriate, and implement guidance issued by the National Headquarters.''[88]

(a) Senior Technical Advisor

The Senior Technical Advisor provides technical advice to the TE/GE Commissioner. The office of this Advisor (1) coordinates with and assists the TE/GE Commissioner, TE/GE Division, other components of the IRS, the Department of the Treasury, the Department of Justice, other government agencies, state government agencies, and congressional committees on ''highly technical and confidential matters of common concern''; (2) conducts studies of

[86]IRM 1.1.23.3 § 3.
[87]*Id*. § 1.
[88]*Id*. § 2.

technical issues to determine whether legislation, regulations, or other public guidance is needed on a particular tax law issue; and (3) reviews the litigating, interpretative, and administrative trends in connection with an IRS position in a particular tax law area to determine whether changes or other IRS actions are warranted.[89]

(b) Planning

The Office of Planning (1) manages the planning activities of TE/GE, including establishment of the strategic direction for the division and its operating units, and development of business goals and performance measures; (2) coordinates the business planning activities, including developing business cases, determining funding priorities, and preparing resource justifications; and (3) develops the budget submission for TE/GE and responds to inquiries about the budget from external stakeholders (Department of the Treasury, Office of Management and Budget, and Congress).[90]

(c) Finance

The Office of Finance (1) manages the resource distribution process, including the development of a financial plan that supports the program priorities of TE/GE; (2) manages the financial resources for TE/GE, including tracking resource usage against targets, and makes projections of resource needs through year-end; (3) establishes financial policies, procedures, and controls for TE/GE in conjunction with overall IRS guidelines and procedures; and (4) works closely with Planning to develop the budget submission for TE/GE and to respond to inquiries from external stakeholders.[91]

(d) Communications and Liaison

The Office of Communications and Liaison (1) facilitates effective communication with TE/GE employees and other internal and external stakeholders; (2) coordinates the development of TE/GE-wide stakeholder partnership strategy and identifies partnering opportunities; (3) develops TE/GE-wide internal communications strategies, plans, and messages; (4) prepares speeches and briefing papers for the TE/GE Division Commissioner and Deputy Commissioner; (5) serves as a central point of contact for programs such as Fed-State, Disclosure, Legislative Affairs, Public Liaison, Internal Communications, and Media Relations; and (6) coordinates meetings of the Advisory Committee on Tax Exempt and Government Entities.[92]

[89]IRM 1.1.23.3.1.
[90]IRM 1.1.23.3.2.
[91]IRM 1.1.23.3.3.
[92]IRM 1.1.23.3.5.

(e) Business Systems Planning

The Office of Business Systems Planning (1) develops strategic information systems plans for the TE/GE Division; (2) gathers and analyzes technology requirements for the Division; (3) assesses the feasibility of technology solutions to address gaps in business processes and assesses the impact on facilities, human resources, and organization structure; (4) develops business cases and requests for information services; (5) develops service-level agreements with the IRS's general Information Services component for services, procurement, and planning; (6) coordinates with the Planning and Finance offices to formulate the information systems budget; and (7) provides program management support and oversight of systems implementation projects to deliver business capabilities.[93]

(f) Research and Analysis

The Office of Research and Analysis (1) identifies and analyzes emerging compliance trends affecting TE/GE component customers, communicating the results to the appropriate operating unit; (2) conducts studies to determine causes for and changes in taxpayer behavior; (3) evaluates and performs benefit analyses of different compliance treatments; (4) analyses internal work practices to maximize efficiencies and improve quality; (5) performs analyses to substantiate and test hypotheses proposed by the operating units; and (6) analyses the impact of policy decisions on the mission and compliance activities of the TE/GE component of the Exempt Organizations Division.[94]

§ 2.5 EXAMINATIONS OFFICE

The Examinations Office within the Exempt Organizations Division[95] focuses on tax-exempt organizations examination programs and review projects. This office:

- Develops and implements measures for the exempt organizations examination program that balance customer satisfaction, employee satisfaction, and business results
- Develops the overall exempt organizations enforcement strategy and goals to enhance compliance consistent with overall TE/GE strategy, and implements and evaluates exempt organizations examination policies and procedures

[93]IRM 1.1.23.3.6.
[94]IRM 1.1.23.3.7.
[95]The EO Examinations function is headquartered in Dallas, Texas.

- Develops and implements the exempt organizations' returns classification and selection process, and the case review and closing processes
- Coordinates with the Directors, TE/GE Research and Analysis, Exempt Organizations Customer Education and Outreach, Exempt Organizations Rulings and Agreements, and TE/GE Customer Accounts Services to identify emerging noncompliance areas, develop proactive education efforts, and identify opportunities for the improvement of exempt organizations processes
- Provides support and resources for Exempt Organizations Customer Education and Communication programs and products
- Coordinates with the Employee Plans Division with respect to examinations of employee plans maintained by tax-exempt organizations
- Monitors and evaluates the quality and effectiveness of the Exempt Organizations Examination programs, and coordinates the peer review process for large case examinations
- Supervises the activities of Exempt Organizations Examination Programs and Review, and the Exempt Organizations Area offices[96]

Exempt Organizations Examinations is comprised of exempt organizations examination specialists, supervised by Exempt Organizations group managers who are supervised by the Exempt Organizations area manager within various geographical areas.[97]

The support functions of the Examinations Office include Examination Planning and Programs, Classification, Mandatory Review, Special Review, and Examinations Special Support. Two important and relevant units within Examinations were inaugurated in 2004: the EOCU and the DAU.

The EOCU is located in the IRS service center in Ogden, Utah. It is composed of revenue agents and tax examiners who address instances of potential tax-exempt organizations' noncompliance with the tax law, based on reviews of annual information returns,[98] and conduct correspondence examinations. Examples of EOCU projects are the focus on charitable organizations that report substantial contributions and little or no fundraising costs[99] and on executive compensation.[100] The EOCU model is contact with a particular exempt organization followed by a monitoring of its subsequent annual information returns.[101] The IRS considers this an efficient and effective approach to maintaining a compliance presence.

[96]IRM 1.1.23.5.3 § 1.
[97]*Id*. § 2.
[98]See App. C § VII A.
[99]See § 4.7.
[100]See § 4.3.
[101]''Standing Toe-to-Toe with the IRS,'' at 130.

The DAU is an office composed of economists, statisticians, and research analysts that assemble and review various databases and other techniques to investigate and determine emerging trends in exempt organizations' operations, in an effort to improve identification and selection of exempt organizations for examination.[102] This office develops strategies to improve compliance by means of examinations, compliance checks, educational programs, and other techniques that may not involve the examination of organizations' books and records. A project may measure overall levels of compliance or it may answer specific questions about a market segment.

The FIU is staffed with fraud specialists, forensic accountants, and agents with expertise in identifying fraud and tracking foreign grant activities. The FIU conducts examinations of organizations identified as potentially involved with fraudulent transactions. This staff also works with law enforcement agencies, such as the Joint Terrorism Task Force and the Criminal Investigation Division, by providing support on criminal investigations and expert testimony at trials involving exempt organization–related issues.

Other pertinent aspects of this organization of the IRS include an Exempt Organizations Electronic Initiatives Office (which became operational in June 2003) that is responsible for the coordination, development, and deployment of new technology in the Exempt Organizations Division, including electronic filing of annual information returns, increased disclosure of filings to the public, and data acquisition and display.[103]

§ 2.6 CUSTOMER EDUCATION AND OUTREACH

The Office of Exempt Organizations Customer Education and Outreach (EO CE&O):

- Develops and implements measures for the EO CE&O program that balance customer satisfaction, employee satisfaction, and business results
- Develops the strategic direction of the nationwide education and outreach programs for EO customers in order to promote ''up-front voluntary'' compliance
- Provides information by means of plain-language publications, seminars and workshops, web sites, and other products to EO customers to assist them in understanding their tax law responsibilities
- Ensures that various educational products and services are tailored to meet the needs of the distinct segments of the EO community

[102] *Id.*

[103] The foregoing summary of the functions of the Examinations office is based in part on information provided in the IRS's Exempt Organizations Implementing Guidelines for the government's fiscal year 2004.

- Coordinates with the Directors, TE/GE Research and Analysis, EO Rulings and Agreements, EO Examinations, and TE/GE Customer Accounts Services to identify emerging areas of noncompliance, develop proactive education efforts, and identify opportunities for the improvement of EO processes
- Coordinates with Employee Plan Division area managers to involve field personnel in the development and delivery of education and outreach programs
- Establishes partnerships with various EO customers and other stakeholders to ensure that EO programs, and education and outreach efforts, meet the needs of customers
- Coordinates the EO customer education and outreach efforts with the Employee Plan and Government Entities customer education and outreach programs, and with the overall TE/GE communication and liaison strategies
- In coordination with other EO functions, develops EO forms and publications, and coordinates the printing and distribution of the forms with the IRS Forms and Publications and Multimedia functions
- Maintains effective communications programs to keep EO customers informed of EO policies, procedures, and laws
- Monitors and evaluates the quality and effectiveness of the EO CE&O programs
- Develops and administers the EO segment on the intranet and Internet web sites in coordination with the Information Systems component and other IRS internal entities as is appropriate
- Supervises the activities of the EO CE&O staff, including CE&O area coordinators[104]

§ 2.7 RULINGS AND AGREEMENTS

The Office of EO Rulings and Agreements (R&A):

- Develops and implements measures for the EO R&A programs that balance customer satisfaction, employee satisfaction, and business results
- Processes determination letter requests from organizations seeking recognition of tax-exempt status
- Provides technical interpretations of laws and procedures relating to exempt organizations by publishing revenue rulings, revenue

[104]IRM 1.1.23.5.1.

procedures, announcements, and notices for the public; providing pre-transactional rulings to specific requestors; and issuing technical advice[105] and technical assistance to IRS personnel

- Participates with Chief Counsel and the Department of the Treasury in the development and issuance of regulations and other published guidance of general applicability, and on legislative matters
- Develops and operates voluntary correction programs, and issues compliance and correction statements or enters into closing agreements[106] under these programs
- Processes applications for changes in or adoption of accounting methods or periods by exempt organizations
- Coordinates with the Directors, TE/GE Research and Analysis, EO CE&O,[107] EO Examinations,[108] and TE/GE Customer Accounts Services[109] to identify emerging noncompliance areas, develop proactive education efforts, and identify opportunities for the improvement of EO processes
- Provides support and resources for EO CE&O programs and products
- Coordinates with Chief Counsel and the Department of Justice on litigation issues (including declaratory judgment cases[110])
- Coordinates with the TE/GE Director, Human Resources, in developing employee training and continuing professional education programs and materials, and maintains effective communications programs to keep employees informed of current policies, procedures, and laws
- Monitors and evaluates the quality and effectiveness of EO R&A programs
- Supervises the activities of EO Determinations, EO Determinations Quality Assurance, EO Technical, and EO Technical Quality Assurance and Guidance functions[111]

§ 2.8 PROGRAM MANAGEMENT

The Office of EO Program Management:

[105]See § 1.9.
[106]See § 1.10.
[107]See § 2.6.
[108]See § 2.5.
[109]See § 2.9.
[110]See § 3.13(b).
[111]IRM 1.1.23.5.2.

- Develops functional workplans in consultation with the Directors, EO CE&O,[112] EO R&A,[113] and EO Examinations,[114] and monitors workplan accomplishments
- Coordinates with TE/GE offices of Planning and Finance[115] in the development of ''balanced measures''
- Assists in the development of business review criteria and participates in field visitation programs
- Assists in the development of the Internal Revenue Manual and other required procedural guidance[116]

§ 2.9 CUSTOMER ACCOUNTS SERVICES

The mission of the Office of Customer Accounts Services (CAS) is to assist TE/GE customers in understanding their federal tax responsibilities and to ensure timely and accurate processing of payments, returns, and other filings. The CAS function oversees service center (campus) programs. To accomplish its mission, the CAS component:

- Designs and implements measures for the CAS function that balance customer satisfaction, employee satisfaction, and business results
- Contracts with service centers for the timely and accurate processing of payments, returns, and other filings of TE/GE customers, and up-front processing of EO determination applications
- Ensures accurate maintenance of the EO business master file and prompt resolution of any account errors
- Participates in equal employment and diversity program activities[117]

§ 2.10 IRS ADMINISTRATIVE FUNCTIONS

The IRS (from its National Office), in addition to development of the agency's nationwide education and outreach programs, prepares and disseminates guidance interpreting the federal tax law (usually, the Internal Revenue Code and then-existing tax regulations). This guidance has the force of law, unless it is overly broad in relation to the statute and/or tax regulation involved, or is unconstitutional.

[112]See § 2.6.
[113]See § 2.7.
[114]See § 2.5.
[115]See § 2.4(b),(c).
[116]IRM 1.1.23.5.4.
[117]IRM 1.1.23.7.

The most formal guidance issued by the IRS (technically, as a function of the Department of the Treasury) is promulgated in the form of *regulations*. This process commences with issuance of the regulations in proposed form for public comment; often the IRS holds a hearing on the proposal. Thereafter, the IRS issues the regulations in final form, either with changes (the usual outcome) or in the form as proposed. On occasion, regulations are issued in proposed form a second time; infrequently, the IRS withdraws proposed regulations or issues temporary regulations. Proposed, temporary, and final regulations are published in the *Federal Register*; regulations in final form are published (as Treasury Decisions) in the *Code of Federal Regulations* and the *Internal Revenue Bulletin*.

IRS determinations on a point of law are more likely issued in the form of *revenue rulings*.[118] The agency states (in each issue of the Internal Revenue Bulletin) that it is its policy to ''publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin.''[119] The IRS adds that revenue rulings ''represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling.''[120] The agency also issues rules of procedure termed *revenue procedures*.[121] The IRS states (in the Bulletin) that procedures ''relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.''

Revenue rulings and revenue procedures are issued on a regular basis; they are sequentially numbered each calendar year, with that number preceded by a two- (in the past) or four-(currently) digit number reflecting the year of issue. For example, the fiftieth revenue ruling issued in 2008 is cited as ''Rev. Rul. 2008-50.'' Likewise, the twenty-fifth revenue procedure issued in 2008 is cited as ''Rev. Proc. 2008-25.''

These IRS determinations are published weekly in the Internal Revenue Bulletin. The IRS states (in each issue of the Bulletin) that this Bulletin is the ''authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest.'' In the foregoing examples, when the determination is first published, a revenue ruling is cited as ''Rev. Rul. 2008-50, 2008-____ I.R.B. ____,'' with the number after the

[118]These rulings are referenced throughout as ''Rev. Rul.'' (see, e.g., § 4.1, note 16).

[119]Revenue rulings apply retroactively unless otherwise indicated.

[120]Also: ''In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.''

[121]These rules of procedure are referenced throughout as ''Rev. Proc.'' (see, e.g., § 1.9, note 75).

second hyphen being the number of the particular issue of the weekly Bulletin and the last number being the page number within that issue on which the item begins.[122] Likewise, the revenue procedure is cited as ''Rev. Proc. 2008-25, 2008-____ I.R.B. ____ .''[123]

Bulletin contents are semiannually compiled into Cumulative Bulletins.[124] The Cumulative Bulletin designation then becomes the permanent citation for the determination. Thus, the permanent citations for these two hypothetical IRS determinations are ''Rev. Rul. 2008-50, 2008-1 C.B. ____'' and ''Rev. Proc. 2008-25, 2008-1 C.B. ____,'' with the first number after the comma being the year of issue, the second number (after the second hyphen) indicating whether the determination is published in the first six months of the year (*1* as in the example) or the second six months of the year (2), and the last number being the page number within that semiannual bound volume at which the determination begins.[125]

Revenue rulings and revenue procedures do not have the force and effect of tax regulations but they may be used as precedent. The IRS notes, however, that, in applying rulings and procedures, the ''effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.''

The IRS also issues forms of ''public'' law in the name of *notices*[126] and *announcements*.[127] A notice is initially published in the Internal Revenue Bulletin, then republished in the Cumulative Bulletin. An announcement, however, although published in the Internal Revenue Bulletin, is not republished in the Cumulative Bulletin. Further, the IRS publishes information in the form of *news releases*;[128] these releases are not published in either the Internal Revenue Bulletin or the Cumulative Bulletin.

In contrast to these forms of ''public'' (precedential) law, the IRS (again from its National Office) also issues ''private'' (nonprecedential) determinations. These documents are principally in the form of *private letter rulings* and *technical advice memoranda*. These determinations may not, according to statutory law, be cited as legal authority,[129] although on occasion such citation

[122]For example, § 4.1, note 16.
[123]For example, § 1.9, note 75.
[124]These publications are cited throughout as ''C.B.'' (e.g., § 1.10(b), note 138).
[125]The last Bulletin for a month includes a cumulative index for the matters published during the preceding months; these monthly indexes are cumulated on a semiannual basis and are published in the last Bulletin of each semiannual period.
[126]See § 4.9(a), note 77.
[127]For example, § 3.13(b)(iii), note 371.
[128]These releases are cited as ''IR,'' followed by the year of issue and the number of the release (e.g., § 4.1, note 9).
[129]IRC § 6110(k)(3).

is undertaken by a court,[130] practitioners and academics (such as in memoranda, court filings, articles, and books), and sometimes the IRS. Nonetheless, these pronouncements can be valuable in understanding IRS thinking on a point of law; certainly in the context of the law of tax-exempt organizations, considerable IRS policymaking is reflected in these private determinations.

The IRS issues private letter rulings in response to written questions (termed *ruling requests*) submitted to the IRS. An IRS field office may refer a case to the IRS National Office for advice (termed *technical advice*); the resulting advice is provided to the IRS field office in the form of a technical advice memorandum. In the course of preparing a revenue ruling, private letter ruling, or technical advice memorandum, the IRS National Office may seek legal advice from its Office of Chief Counsel; the resulting advice was provided, until recently, in the form of a *general counsel memorandum*;[131] this memorandum has been replaced by the *chief counsel advice memorandum*.[132] These four types of documents are made public, albeit in redacted form.

Private letter rulings[133] and technical advice memoranda[134] are identified by seven- or nine-digit numbers (depending on the year involved), as in ''Priv. Ltr. Rul. 200825007.'' The first two or four numbers are for the calendar year involved (here, 2008), the next two numbers reflect the week of the year involved (here, the twenty-fifth week of 2008), and the remaining three numbers identify the document as issued sequentially during the particular week (here, this private letter ruling was the seventh one issued during the twenty-fifth week of 2008).

§ 2.11 APPEALS

The Appeals function within the IRS serves as the administrative forum for any taxpayer contesting an IRS compliance action.[135] The mission of this

[130]The U.S. Court of Appeals for the Sixth Circuit affirmed the U.S. Tax Court in concluding that contributions of conservation easements satisfied the requirements for qualified conservation contributions (*Glass v. Comm'r*, 471 F.3d 698 (6th Cir. 2006)). In so doing, this appellate court cited two IRS private letter rulings in rebuffing the government's arguments. In one of these instances, the court expressly recognized that a private letter ruling cannot be used as precedent, yet added that a private letter ruling ''provides persuasive authority for refuting the Commissioner's argument'' (at 709). Later in this opinion, the court referenced another private letter ruling as providing ''persuasive authority'' contrary to the position assumed by the IRS (at 711).

[131]There are no IRS general counsel memoranda referenced in this book; see, however, *Tax-Exempt Organizations* § 4.3(a), note 67.

[132]There are no IRS chief counsel advice memoranda referenced in this book; see, however, *Tax-Exempt Organizations* § 7.3(c), note 83.

[133]Private letter rulings are cited throughout as ''Priv. Ltr. Rul.'' (e.g., § 1.6(a), note 49).

[134]There are no IRS technical advice memoranda referenced in this book; see, however, *Tax-Exempt Organizations* § 4.6, note 239.

[135]The origin of this component of the IRS is traced to August 1, 1927, when the Commissioner of Internal Revenue established a Special Advisory Committee to provide an appeal for cases pending before the Board of Tax Appeals, which is the predecessor to the U.S. Tax Court.

component of the agency is to ''resolve tax controversies, without litigation, on a fair and impartial basis'' from the standpoint of the federal government and the taxpayer, and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the IRS.[136] The agency defines the term *Appeals Office* to mean any office under the direction and control of the Chief, Appeals, noting that the Appeals Office is independent of EO Determinations and EO Technical.[137]

(a) Organization, Priorities, and Mission

The strategic priorities of the IRS Appeals function are as follows:

- Address the changing and growing inventory of cases (today, about 68,000).
- Reduce the length of the appeals process.
- Improve the quality of referrals to Appeals.
- Implement Appeals tax shelter resolution strategies.
- Improve stakeholder and customer awareness of appeals rights and processes.
- Promote employee productivity, engagement, and satisfaction.
- Implement Appeals presence in campus environments.

The Chief, Appeals, reports to the Commissioner of Internal Revenue and is responsible for planning, managing, directing, and executing nationwide activities for Appeals.[138] The Office of the Deputy Chief, Appeals assists the Office of the Chief, Appeals.[139] The Offices of the Director, Strategy and Finance,[140] Business Systems Planning,[141] and the Director, Field Operations provide additional assistance to the Chief, Appeals.[142]

To accomplish its mission, Appeals:

- Works with the Commissioner of Internal Revenue to ensure an independent appeals process
- Develops and implements Appeals measures that balance customer satisfaction, employee satisfaction, and business results
- Manages Appeals human capital resources through a Strategic Human Capital Plan that articulates workforce needs and strategies to meet them

[136]Rev. Proc. 2007-52, 2007-30 I.R.B. 222 § 1.01(5); IRM 1.1.1.3 § 2A; IRM 1.1.7.1 § 1.
[137]Rev. Proc. 2007-52, 2007-30 I.R.B. 222 § 1.01(5).
[138]IRM 1.1.7.1 § 2.
[139]IRM 1.1.7.2.
[140]IRM 1.1.7.3.
[141]IRM 1.1.7.4.
[142]IRM 1.1.7.5.

- Ensures that Appeals programs meet taxpayer requirements
- Assists Appeals customers in understanding the appeals process and their rights by providing information by means of plain-language publications, seminars, workshops, web sites, and other products
- Provides taxpayers a variety of alternative dispute resolution forums to resolve taxpayer disputes without litigation, including face-to-face and telephone conferences, resolution through correspondence, fast-track mediation services, formal mediation services, and early referral of cases to Appeals
- Provides taxpayers with an administrative appeal on disputes regarding requests made under the Freedom of Information Act[143]
- Provides practitioners with an administrative appeals process regarding IRS determinations to withhold or remove electronic filing authority
- Supports taxpayers' needs for a high-quality review of art object appraisals and evaluations, along with the provision of expert witness testimony in litigated cases on art object appraisals and evaluations
- Conducts research on an ongoing basis to gather data regarding Appeals determination results and provides feedback to IRS operating divisions
- Participates in equal employment and diversity program activities[144]

Appeals constantly looks for ways to reduce the length of the appeals process to better meet taxpayer needs. Traditionally, Appeals held mostly face-to-face conferences. Although still available, Appeals encourages telephone or correspondence conferences when they can significantly shorten the overall time of the appeals process, thereby reducing taxpayer burden.[145]

Appeals handles matters concerning appeals of nearly all tax issues before the IRS, including income, estate, gift, excise, and employment taxes, and cases involving offers-in-compromise, refund claims, penalty appeals, pension plans, and tax-exempt organizations.[146]

(b) Appeals Function and Tax-Exempt Organizations

An IRS appeals officer is likely to view a tax-exempt organization's circumstances differently (i.e., more sympathetically) than did the examining agent. The typical pattern is that the examiner will take a hard position in the case, such as proposing revocation of exemption or imposition of a substantial penalty, with the appeals officer willing to work with the organization in preserving its exemption or reducing the penalty. An appeals officer usually will interpret the

[143]See § 1.11.
[144]IRM 1.1.7.1 § 3.
[145]This paragraph is based on text at the IRS web site.
[146]IRM 1.1.7.1 § 4.

law more favorably, from the exempt organization's standpoint, than did the IRS examiner; an appeals officer may be more flexible in allowing an exempt organization to change one or more aspects of its operations (if necessary) to retain exemption (or enable an entity to obtain recognition of exemption).[147]

IRS appeals officers in general like to resolve tax law disputes by compromising on amounts due, such as taxes and/or penalties. Often the amount at issue will be halved, simply to close the case. In the tax-exempt organizations context, that approach works when the amount at issue is a penalty for failure to timely file an annual information return or an assessment of unrelated business income tax. This approach cannot be taken, of course, when the issue is tax-exempt status.[148] Nonetheless, an organization with a case involving eligibility for exemption on appeal may find that the appeals officer will uphold exempt status if the organization pays a certain amount of money to the IRS. This sum (which usually is negotiable) may be rather arbitrary, being the officer's determination as to what is fair recompense to the government for having to process the case.[149]

§ 2.12 OFFICE OF NATIONAL TAXPAYER ADVOCATE

The Taxpayer Advocate Service (TAS), headed by the National Taxpayer Advocate, is an independent office within the IRS;[150] it commenced operations in its contemporary form on March 12, 2000. The mission of the TAS is to help taxpayers resolve problems with the IRS and to recommend changes to prevent taxpayer problems.[151] TAS employees assist taxpayers who are experiencing economic harm, who are seeking help in resolving tax problems that have not been resolved through normal channels, or who believe that an IRS system or procedure is not working as it should.

(a) Mission Fulfillment

The TAS mission is fulfilled through taxpayer casework and advocacy initiatives. The TAS handles not only cases in which a taxpayer is suffering or

[147]In one instance, an exempt organization made some material changes in its programs to help secure a favorable determination from the appeals officer. The IRS examiner contended that the making of the changes was ''proof'' that the organization was ineligible for exemption for the years under examination. The appeals officer explicitly stated (verbally) that that argument was being ''ignored.''

[148]As one appeals officer stated the matter, an organization cannot be ''partially exempt.''

[149]On more than one occasion, the proposed sum is roughly equivalent to the income tax the organization would have had to pay were it a taxable entity during the examination period. That approach can work where most of the organization's revenue consists of fee-for-service and investment income; it is less successful where the revenue is largely in the form of contributions (and grants) inasmuch as gifts are not forms of *gross income* (IRC § 102). See *Tax-Exempt Organizations* § 26.4(a).

[150]IRC §§ 7803, 7811; IRM 1.1.8.

[151]The TAS ''[h]elps taxpayers resolve problems with the IRS and recommends systemic changes'' (IRM 1.1.1.3 § 2B).

about to suffer a significant hardship but also cases in which a taxpayer, while not experiencing a hardship, would benefit from the office's involvement. Where the TAS cannot provide a remedy for taxpayers because of deficiencies in administrative procedures or barriers imposed by the tax law, the office will propose administrative solutions or legislative changes.

(b) Organization

Unlike most of the IRS today, the TAS continues be a geographically based organization. The field organization consists of nine Area Taxpayer Advocate Directors, seven of whom oversee casework by Local Taxpayer Advocates in assigned territories and two of whom oversee casework from Local Taxpayer Advocates in service centers. The field organization also includes two Operating Division Taxpayer Advocates, who are responsible for systemic analysis and advocacy. The Area Taxpayer Advocate Directors and the Operating Division Taxpayer Advocates report directly to the National Taxpayer Advocate. Seventy-four Local Taxpayer Advocates report to the Area Taxpayer Advocate Directors and are responsible for handling taxpayer cases at the local level.

Inasmuch as the TAS is structured around geographical, rather than taxpayer, segments, Taxpayer Advocates handle all categories of taxpayer issues, irrespective of the subject matter, in their assigned territories. Thus, all taxpayers in a locality who desire the services of the TAS go to the same advocate office, whether the taxpayer is a small business, a large corporation, a wage earner, or a government entity. Local and area advocates are concerned primarily with casework issues, that is, issues involving specific taxpayers rather than broad organizational issues.

Broad organizational issues are handled by the Advocacy Analysts assigned to and remotely managed by the Operating Division Taxpayer Advocates. Advocacy issues are generally those issues that impact a large segment of taxpayers or are issues that recur with some frequency. Depending on the nature of the problem presented, Advocacy Analysts will recommend either administrative solutions to the IRS or legislative solutions to Congress, by means of the National Taxpayer Advocate's *Annual Report*.[152]

(c) General Rules

A person may be eligible for TAS assistance if the person:

- Is experiencing economic harm or significant cost (such as fees for professional representation)
- Has experienced a delay of more than 30 days to resolve the tax issue

[152]This summary is from the IRS web site.

- Has not received a response or resolution to the problem by the date that was promised by the IRS

There is no cost for this service, it is confidential, and it is available for organizations and individuals. There is at least one local Taxpayer Advocate in each state and in the District of Columbia and Puerto Rico. The TAS office asserts that it ''know[s] the [federal] tax system and how to navigate it.'' If a person qualifies, he, she, or it will receive ''personalized service'' from a ''knowledgeable advocate'' who will listen to the situation, help the person understand what needs to be done to resolve it, and stay with the person ''every step of the way'' until the problem is resolved.[153]

(d) Systemic Advocacy

The mission of the TAS ''reaches beyond individual cases and extends into the realm of systemic advocacy.'' This means that the TAS tries to ''repair *systemic* flaws in the IRS and the tax code, which can cause trouble for taxpayers and IRS employees alike.'' Systemic advocacy issues always affect multiple taxpayers; they affect segments of the taxpayer population, locally, regionally, or nationally; they relate to IRS systems, policies, and procedures; they require study, analysis, and administrative changes or legislative remedies; and they involve protecting taxpayer rights, reducing or preventing taxpayer burden, ensuring equitable treatment of taxpayers, or providing essential services to taxpayers.

The TAS receives issues through the Systemic Advocacy Management System (SAMS), which is a database of issues, ideas, and suggestions from the public and IRS employees. An issue may be submitted to SAMS and the TAS Office of Systemic Advocacy by means of the IRS web site.[154]

(e) TAS and Tax-Exempt Organizations

There is no TAS process that is unique to tax-exempt organizations. Nonetheless, the TAS function is available in the exempt organizations context. Thus, in the form cover letter sending the IRS's report of examination to a tax-exempt organization,[155] reference is made to the office of the Taxpayer Advocate. This letter states that, although the organization has a ''right'' to contact this office, Taxpayer Advocate assistance ''is not a substitute for established IRS procedures, such as the formal appeals process.''[156] The letter also states that the Taxpayer Advocate ''cannot reverse a legally correct tax [law] determination, or extend the time fixed by law that you have to file a

[153] *Id.*
[154] *Id.*
[155] See § 5.33.
[156] As to that process, see § 2.11.

petition in a United States court'' but adds that the Taxpayer Advocate ''can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling.'' Therefore, for example, if there are undue delays in the IRS processing of an exempt organizations matter, such as an appeal, the office of the Taxpayer Advocate may be of assistance.[157]

§ 2.13 PRACTICE BEFORE IRS

The concept of *practice before the IRS* encompasses all matters in connection with presentations to the agency regarding a taxpayer's rights, privileges, or liabilities pursuant to laws administered by the IRS. These *presentations* include corresponding and otherwise communicating with the IRS; representing a taxpayer at conferences, hearings, or other meetings with the IRS; preparing and filing documents with the IRS on behalf of a taxpayer; and the provision of written advice with respect to an entity, transaction, plan, or arrangement.[158]

The IRS Office of Professional Responsibility is responsible for communicating and enforcing the standards of competence, integrity, and conduct among those who represent taxpayers before the IRS. These representatives include lawyers,[159] certified public accountants, enrolled agents, enrolled actuaries, and appraisers.[160] Regulations provide the rules governing the representation of taxpayers before the IRS.[161] These regulations are republished by the IRS in Treasury Department Circular 230, the provisions of which set forth guidance as to who may represent taxpayers, the process for becoming an enrolled agent, the duties and restrictions relating to practice, and the process for resolving allegations of violations of these duties and restrictions.[162]

[157]In one instance, an IRS appeals officer was presiding over an appeal for over 12 months, and would not respond to telephone calls or correspondence. A written submission to the TAS was made on behalf of the tax-exempt organization involved, essentially complaining about the delay and lack of attention to the case. The appeals officer called the lawyer for the exempt organization four days following the submission.
[158]IRM 1.25.1.1 § 1.
[159]See § 3.4, note 234.
[160]*Id*. § 2.
[161]31 Code of Federal Regulations, Part 10.
[162]IRM 1.25.1.2.

CHAPTER THREE

Managing Tax-Exempt Organizations IRS Audits

Managing an IRS audit of a tax-exempt organization (or, for that matter, any other type of IRS examination or inquiry) involves far more than law—diplomacy and psychology are also in play. Even the concept of *management* of an IRS audit is somewhat of an anomaly; a representative of an exempt organization (such as an executive, a lawyer, or an accountant) should be cautious when presuming that the IRS is going to be *managed* in any meaningful way. It can be done but, if not checked within reason, it will be the IRS that does most, if not all, of the managing. For the most part, all that can be hoped for in this regard is that the exempt organization will manage its conduct during the examination and hope to have a positive influence on what the IRS does during the process, and that the professional(s) representing the exempt organization during the audit will speak up when necessary, enforce rights if required to do so, and function as an advocate of the exempt organization (without unduly annoying the representative(s) of the IRS).

A tax-exempt organization can take certain steps, in advance of any IRS audit, to improve its position. Given the resources of the IRS and the number of exempt organizations, the likelihood of a particular exempt organization getting audited (what is sometimes ruefully referred to as ''winning the audit lottery''[1]) is slim indeed. Nonetheless, in part because of good management considerations and in part because of an increasing likelihood of an IRS audit, the prudent exempt organization will follow these steps. There are additional steps to be taken immediately following receipt of notice of an IRS audit. There are, not surprisingly, still further steps to be taken once the audit is underway.

§ 3.1 PRE-AUDIT PRECAUTIONS

The following is an inventory of steps that a tax-exempt organization should consider to improve and maximally enhance what one commentator termed its ''public face'' in advance of any IRS examination that will have the ''dual effect of reducing the chances of an examination ever occurring, or if one does begin, [moving] to its conclusion as quickly and efficiently (and cheaply) as possible.''[2]

(a) Review Governing Instruments

The tax-exempt organization should, from time to time, review its governing instruments. The place to start is what is formally known as the organization's *articles of organization*[3]—the document by which the entity was

[1]For example, Owens, ''Katie Bar the Door! IRS Audit Plans and How to Deal with Them,'' outline of presentation on March 1, 2007, at 61, *43rd Annual Washington Non-Profit Legal & Tax Conference* (Washington Non-Profit Tax Conference, Inc.) (''How to Deal with IRS Audits''). See § 3.2.

[2]*Id*. at 59. These steps are collectively (and cleverly) referred to as ''hardening the target'' (see § 3.3). Also ''Standing Toe-to-Toe with the IRS,'' at 134–136.

[3]See App. C § II A.

constituted. This generally is the organization's articles of incorporation, constitution, trust agreement, or declaration of trust. This exercise is to ensure that this document accurately describes the organization's purposes and fully comports with the applicable organizational test.[4] Also, bylaws and similar documents should be reviewed from this perspective.[5]

The IRS examiner will definitely review these documents, as illustrated by the following:

- In the case of an exempt single-member title-holding company,[6] the examiner will check to see if the entity is organized for the exclusive purpose of holding title to property and if it has more than one parent organization.[7]
- In the case of an exempt religious organization,[8] an examiner will review the organization's creating document to ensure that the entity is organized exclusively for religious purposes.[9]
- In the case of a supporting organization,[10] an examiner will review governing instruments to ascertain whether the organization is meeting the applicable organizational requirements.[11]
- In the case of an exempt social welfare organization,[12] an examiner will review the organizing document and bylaws to determine if the organization is a membership organization and, if so, what rights, privileges, and services are offered to the members.[13]
- In the case of an exempt local association of employees,[14] an examiner will review the organizing document and bylaws to ascertain the organization's membership requirements and determine whether membership is properly limited to employees of a designated employer or employers in a locality.[15]
- In the case of an exempt fraternal organization operating under a lodge system,[16] an examiner will inspect the charter of each of the subordinate

[4] *Id*.
[5] The IRS often will accord an organization the opportunity to amend one or more of its governing instruments to bring them into compliance with the legal requirements, although that remedy may operate only prospectively.
[6] See App. C § I A.
[7] IRM 4.76.1.3.1 §§ 2.3. These examination guidelines are summarized in Chapter 7.
[8] See App. C § I C.
[9] IRM 4.76.6.6 § 1.
[10] See App. C § V D.
[11] IRM 4.76.3.8.1 § 2.
[12] See App. C § I I.
[13] IRM 4.76.13.4.1 § 3.
[14] See App. C § I J.
[15] IRM 4.76.13.5.1 § 1.
[16] See App. C § I O.

lodges to verify that it is recognized as a subordinate lodge by the parent organization.[17]

- In the case of an exempt supplemental unemployment benefit trust,[18] an examiner will review the trust instrument to verify that the plan provides only supplemental unemployment benefits and subordinate sick and accident benefits.[19]
- In the case of an exempt veterans' organization,[20] an examiner will review the organization's articles of organization and bylaws to determine the composition of the entity's membership.[21]
- In the case of a multi-parent title-holding corporation,[22] an examiner will review the organizing document to determine if the entity is organized exclusively to hold title to property.[23]
- In the case of a charitable remainder trust,[24] an examiner will study the trust document to determine if it meets all of the required organizational standards.[25]

(b) Review Operations

The IRS will obviously inquire into the tax-exempt organization's programs and other activities. The organization should have sufficient documentation about each of its programs, and the relationship between these programs and achievement of its exempt purposes. Documentation of this nature that is in the organization's files when the IRS arrives is far more potent than materials assembled after the agency has initiated contact with the entity. This effort is directed at ensuring that the exempt organization is in compliance with the applicable operational test.[26]

Here are some illustrations of these points:

- In the case of an exempt single-member title-holding company,[27] an IRS examiner will analyze the organization's disbursements to determine if it is distributing its net income to the parent organization.[28]

[17]IRM 4.76.17.3.1 § 2.
[18]See App. C § I W.
[19]IRM 4.76.25.3.1 § 1A.
[20]See App. C § I X.
[21]IRM 4.76.26.4.2 § 1A.
[22]See App. C § I Z.
[23]IRM 4.76.28.3.1 § 1.
[24]See App. C § XIII D.
[25]IRM 4.76.5.1.4 § 4.
[26]See App. C § II B.
[27]See *id*. § I A.
[28]IRM 4.76.1.5.1 § 2.

- In the case of an exempt social welfare organization,[29] an examiner will review activities, expenditures, and publications of the entity to identify any legislative or political campaign expenditures or activities.[30]
- In the case of an exempt voluntary employees' beneficiary association,[31] an examiner will review the entity's operations to determine who controls it, the employment-related common bond, and the benefits that are provided.[32]
- In the case of an exempt credit union,[33] an examiner will review the entity's operations to determine if it is operated for mutual purposes and not for profit.[34]
- In the case of an exempt small insurance company,[35] an examiner will review the organization's operations looking for evidence that its primary activities are not the issuance of insurance.[36]
- In the case of an exempt charitable organization conducting fundraising,[37] an examiner will determine if, in its solicitation or other materials, the organization is clearly designating the amount of the payment that is attributable to the purchase of admission or other privilege and the portion that is deductible as a charitable contribution.[38]

(c) Review Books and Records

This matter of books and records is discussed more fully elsewhere;[39] at this point, it is sufficient to note that they can be classified as governance, operational (e.g., grant files), and financial in nature. The tax-exempt organization should be certain that it knows where these records are located and that they contain what is required. The organization should establish a records retention policy and adhere to it.

Here are some examples of IRS review of these records:

- An IRS examiner will review the financial records of a charitable organization that is claiming to be publicly supported.[40]

[29]See App. C § I I.
[30]IRM 4.76.13.4.2.1 § 1.
[31]See App. C § I P.
[32]IRM 4.76.18.3.
[33]See App. C § I T.
[34]IRM 4.76.22.3 § 1.
[35]See App. C § I U.
[36]IRM 4.76.23.4 § 1C.
[37]See App. C § XIV.
[38]IRM 4.76.51.3.1 § 3.
[39]See, e.g., § 5.19(b)(i).
[40]IRM 4.76.3.5.6. See App. C § V C.

- In the case of a charitable organization, an examiner will test payroll accounts for evidence of employee involvement in political campaign activity[41] ''on company time.''[42]
- In the case of an exempt labor organization,[43] an examiner will analyze cash disbursement records and supporting documents for unusual purchases of supplies (such as purchases from a clothing store recorded as ''other expenses'' perhaps indicating the payment of personal expenses).[44]
- In the case of an exempt business league,[45] an examiner will analyze the organization's bank statements and disbursement journals to determine whether it is maintaining a separate segregated fund for the purpose of making political expenditures.[46]
- In the case of an exempt veterans' organization,[47] an examiner will analyze cash receipts and supporting documents to identify any ''unusual or potentially taxable'' sources of income, such as operation of a banquet hall or sale of liquor for off-premises consumption.[48]
- In the case of an exempt black lung benefits trust,[49] an examiner will review the receipts and disbursement journals, and supporting documents, to verify the organization's annual information returns and to identify any unusual sources of income or disbursements.[50]
- In the case of a charitable remainder trust,[51] an examiner will review the charitable organization's records to ascertain the nature of property transferred to the trust and the date of the transfer(s).[52]

(d) Review Publications

A tax-exempt organization should also review, from the same perspective, its publications that are disseminated to the public. Examples of these are magazines, journals, newsletters, mission statements, annual reports, audited financial statements, and federal or state lobbying disclosure reports. These materials should be reviewed to identify any statements that may be incon-

[41]See App. C § IV.
[42]IRM 4.76.3.13.3 § 1G.
[43]See App. C § I K.
[44]IRM 4.76.14.3.2.1 § 6.
[45]See App. C § I M.
[46]IRM 4.76.15.8.1 § 3.
[47]See App. C § I X.
[48]IRM 4.76.13.6.1 § 4.
[49]See App. C § I Y.
[50]IRM 4.76.27.4, 4.76.27.5 § 1.
[51]See App. C § XIII D.
[52]IRM 4.76.5.1.4 § 5.

sistent with the organization's tax-exempt status.[53] Usually the text cannot be amended, but at least the organization and its professional representatives can become aware of the problematic language and prepare accordingly. Moreover, the organization should be certain that the information reported in these documents is consistent with the information in its federal (and state) returns.

Here are some illustrations:

- In the case of an exempt charitable organization, an IRS examiner will review the organization's publications in search of lobbying efforts.[54]
- In the case of an exempt charitable organization, an IRS examiner will review the organization's newsletters for mention of a political figure or political event.[55]
- In the case of an exempt charitable organization that is claiming publicly supported charity status based on the facts-and-circumstances test,[56] an examiner will review the organization's publications to consider how it makes itself and its mission known to the public.[57]
- In the case of an exempt religious organization,[58] an examiner will review the organization's publishing activities to determine if they are distinguishable from those of a for-profit enterprise.[59]
- In the case of an exempt business league, an examiner will review the organization's publications to determine whether they contain advertising that names only the products or services of its members or may subject the organization to unrelated business taxation.[60]
- In the case of an exempt fraternal organization,[61] an examiner will review the organization's newsletters and flyers to determine if contributions for charitable purposes have been received.[62]

[53] An organization was recognized by the IRS as a tax-exempt entity by reason of IRC § 501(c)(3). The primary activity of the organization was publication of a magazine titled *Flying Adventures: The Private Aircraft Owners/Passengers Travel & Lifestyle Magazine*. The IRS conducted a field audit of this entity (in an airplane hangar). The founder of the organization asserted that the principal purpose of the magazine is the teaching of flying safety. Perusing issues of this magazine, the auditing agent found little material about flying safety but came upon a disclaimer in each issue: ''This publication is strictly for your entertainment value.'' The IRS revoked the organization's exempt status (Priv. Ltr. Rul. 200709064 (July 27, 2006)).
[54] IRM 4.76.2.4.1 § 2. See App. C § III.
[55] IRM 4.76.3.13.3 § 1A. See App. C § IV.
[56] See App. C § V C.
[57] IRM 4.76.3.5.4 § 5D.
[58] See App. C § I C.
[59] IRM 4.76.6.6 § 5F.
[60] IRM 4.76.15.5.1 § 2. See App. C § I X.
[61] See App. C § I Q.
[62] IRM 4.76.17.10.1 § 2.

(e) Review Correspondence

Reviewing correspondence (including e-mail) can be a tedious exercise, but it must be done because an IRS examiner is likely to do so. Here are some examples:

- When an examiner is reviewing the financial support of a charitable organization that is claiming to be publicly supported,[63] he or she will review its correspondence to ensure that contributions were not earmarked for another recipient and to determine if there are grants or contributions that may not be subject to the 2 percent threshold.[64]
- In the case of an exempt private school, an examiner will review correspondence to determine bases for accepting or rejecting applications from potential students and for financial assistance.[65]
- In the case of an exempt cemetery company,[66] an examiner will review the organization's correspondence to ascertain if contributions were for the perpetual care of a particular lot or crypt, rather than for the cemetery in its entirety.[67]

(f) Review Minutes

The IRS examiner is certain to read the tax-exempt organization's governing board (and, if they exist, committee) meeting minutes for the examination period and perhaps other periods. Of all of the types of documents that will be read by the examiner, only board minutes have the ability to be created specifically in anticipation of (and in an attempt to influence the outcome of) an IRS (or other governmental agency) review of the organization's operations. Other than veracity and reasonableness as to length, there are no bounds to the creative uses of minutes; here is the place that the exempt organization can best contemporaneously explain its programs and policies to a government inspector. Indeed, lawyers have been known to advise their client exempt organizations to prepare their minutes with the assumption that they will be read by an IRS auditor (and/or appear as an exhibit in a court trial); the prudent organization will have legal counsel review board minutes before they are prepared in final form.[68]

Here are some illustrations of what the IRS may be looking for in review of an exempt organization's minutes:

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[63]See App. C § V C.
[64]IRM 4.76.3.5.6 §§ 1D, 1F.
[65]IRM 4.76.8.6 § 3E. See App. C § I D.
[66]See App. C § I S.
[67]IRM 4.76.21.8 § 2A.
[68]See *Planning Guide*, Chapter 1, at 17–19.

- In the case of a membership organization, the examiner will review the organization's minutes to determine whether the dues payments are being used for general support of the organization or used for a form of private benefit.[69]
- In the case of a supporting organization,[70] an examiner will review the organization's minutes to determine the extent of control by one or more supported organizations and by disqualified persons.[71]
- In the case of a supporting organization, an examiner will peruse the organization's minutes to ascertain whether the entity is distributing funds to impermissible beneficiaries.[72]
- In the case of a charitable organization, an examiner will read the organization's minutes looking for mention of a political figure or political event.[73]
- In the case of a religious organization,[74] an examiner will review the entity's minutes to ascertain whether it is engaging in activities that violate public policy.[75]
- In the case of a private school, an examiner will review the entity's minutes to determine whether the school is complying ''in good faith'' with its racially nondiscriminatory policies and activities.[76]
- In the case of an exempt scientific organization,[77] an examiner will review the minutes to determine if the organization retains the ownership or control of more than an insubstantial portion of the patents, processes, or formulas resulting from its research, and does not make these items available to the public.[78]
- In the case of an exempt business league,[79] an examiner will review the minutes to identify the types of benefits provided to the organization's officers and members.[80]

[69]IRM 4.76.3.6.6 § 1.
[70]See App. C § V D.
[71]IRM 4.76.3.8.1 § 2, 4.76.3.8.5 § 2.
[72]IRM 4.76.3.8.4 § 1A.
[73]IRM 4.76.3.13.3 § 1A. See App. C § IV.
[74]See App. C § I C.
[75]See *id*. § II H. IRM 4.76.6.6 § 2D.
[76]IRM 4.76.8.6 § 6. See App. C § I D.
[77]See App. C § I G.
[78]IRM 4.76.12.2.1 § 2.
[79]See App. C § I M.
[80]IRM 4.76.15.4.1 § 1.

- In the case of an exempt credit union,[81] an examiner will review the minutes to determine if the organization is operated for mutual purposes.[82]
- In the case of an exempt multi-parent title-holding corporation,[83] an examiner will review the minutes to determine whether or the extent to which shareholders or beneficiaries exert the requisite control.[84]
- In the case of an exempt organization engaged in gaming activities,[85] an examiner will review the organization's board minutes in an attempt to understand why the organization made the decision to conduct gaming.[86]
- In the case of an exempt organization that engaged in fundraising,[87] an examiner will review board meeting minutes (and those of any development committee) in search of any ''conditional contributions that may have questionable terms.''[88]

(g) Review Federal Returns

The principal returns that will be examined include the annual information return(s) (such as Form 990 or Form 990-PF) and any unrelated business income return (Form 990-T).[89] Tax-exempt organizations should endeavor, in any event, to properly prepare and timely file these returns; they should also be reviewed from time to time from a prospective audit perspective. To be avoided are ''gaps or incongruities'' and ''entries [not] credible on their face,'' such as significant contributions from the public and little or no reported fundraising expenses or compensation reported for a lobbyist but no corresponding lobbying expenses reported in the section concerning attempts to influence legislation.[90]

Here are some examples of IRS examinations of federal returns:

- An examiner will review the annual information return(s) of an exempt organization for items that could indicate issues in the context of private inurement,[91] private benefit,[92] and/or excess benefit transactions.[93]

[81]See App. C § I T.
[82]IRM 4.76.22.3 § 2.
[83]See App. C § I Z.
[84]IRM 4.76.28.4.1 § 1.
[85]See App. C § XII A.
[86]IRM 4.76.50.3.1 § 9.
[87]See App. C § XIV.
[88]IRM 4.76.51.9.1 § 6.
[89]See App. C § VII A, C.
[90]''How to Deal with IRS Audits,'' at 60.
[91]See App. C § II D.
[92]See *id*. § II E.
[93]IRM 4.76.3.11.5 § 2. See App. C § II F.

- An examiner will review the Forms W-2 provided to employees to determine if all economic benefits were properly included in gross income.[94]
- An examiner of an exempt labor organization[95] will review Forms W-2 and 1099 to determine whether strike fund and/or lockout benefits, and/or lost time payments, were reported to its members.[96]
- An examiner of an exempt fraternal organization[97] will inquire as to whether the organization provided a Form 1099-MISC to bands and other entertainers who provide services at social events.[98]
- An examiner of an exempt apostolic organization[99] will inquire as to whether the entity is correctly preparing and annually filing Form 1065.[100]
- An examiner of an exempt political organization[101] will determine whether the entity timely and correctly filed or is filing Forms 8871, 8872, 990, and/or 1120-POL.[102]
- An examiner of an exempt organization conducting gaming activities[103] will determine whether the organization is preparing Forms W-2G.[104]
- An examiner of an exempt organization conducting fundraising activities[105] will determine if the revenue from the activities is being properly reported on the organization's annual information return (usually, Form 990).[106]

(h) Review Contracts

In anticipation of the IRS doing so, an exempt organization should review its contracts (including letter agreements and what it considers to be informal memoranda signed by it and one or more other parties). Of particular interest to the IRS are employment contracts, fundraising contracts, management agreements, and leases. For example, the IRS's tax-exempt organizations' examination guidelines[107] state that an exempt charter school ''must show

[94]IRM 4.76.3.11.5 §§ 4, 6.
[95]See App. C § I K.
[96]IRM 4.76.14.3.5.1.1 § 5, 4.76.14.3.5.2.1 § 3.
[97]See App. C § I O.
[98]IRM 4.76.17.8 § 2.
[99]See App. C § I AA.
[100]IRM 4.76.29.2 § 2A.
[101]See App. C § I BB.
[102]IRM 4.76.30.3.8, 4.76.30.3.9, 4.76.30.3.10.
[103]See App. C § XII A.
[104]IRM 4.76.50.13.3 § 1.
[105]See App. C § XIV.
[106]IRM 4.76.51.9.
[107]See Chapter 7.

that contracts, especially comprehensive management contracts, have been negotiated at arm's length and are for the benefit of the school rather than the service provider'' and ''[b]oilerplate contracts may be an indicia that the terms of the contract were not the subject of negotiations between independent parties.''[108]

If a tax-exempt organization has ''highly paid employees'' with employment contracts, it should be certain that copies of the contracts are in the appropriate personnel files. Also, the organization should have appropriate documentation justifying the amounts of the compensation and the process by which they were set.[109]

Here are some examples of IRS review of an exempt organization's contracts:

- In the case of an exempt organization that is claiming to be publicly supported as a service provider entity,[110] an examiner will analyze contracts that generate receipts for the organization, looking to determine if ostensible grant support is in fact revenue in the form of exempt function revenue.[111]
- In the case of an exempt charitable organization or social welfare organization,[112] an examiner will review employment contracts looking for instances of private inurement,[113] private benefit,[114] and/or excess benefit.[115]
- An examiner will review a fundraising agreement to determine if the fundraiser is exercising any control over the exempt organization and if there is any unrelated business income.[116]
- In the case of an exempt charitable organization, an examiner will review contracts to determine if the organization is lending or sharing equipment in the context of a political campaign.[117]
- In the case of an exempt business league,[118] an examiner will review any contracts with outside lobbyists to determine the extent and nature of the lobbying.[119]

[108]IRM 4.76.8.8.2 § 4. It is not known why exempt charter schools have been singled out in this regard.
[109]*Id*.
[110]See App. C § V C.
[111]IRM 4.76.3.6.6 § 4.
[112]See App. C § I I.
[113]See *id*. § II D.
[114]See *id*. § II E.
[115]IRM 4.76.3.11.5 § 5. See App. C § II F.
[116]IRM 4.76.3.11.5 § 11. See App. C § IX.
[117]IRM 4.76.3.13.3 § 1 C. See App. C § IV A.
[118]See App. C § I M.
[119]IRM 4.76.15.7.1 § 4.

- In the case of an exempt social club,[120] an examiner will review management contracts to identify any inappropriate relationships the club may have with the manager or management company.[121]
- In the case of an exempt voluntary employees' beneficiary association,[122] an examiner will review contracts with insurance companies that provide benefits to ensure that the policy is in the name of the organization and that only permitted benefits are being provided.[123]
- In the case of an exempt veterans' organization,[124] an examiner will review the organization's leases and other contracts to identify possible nonexempt activities that could jeopardize its exempt status or subject it to unrelated business income tax.[125]
- In the case of an exempt political organization,[126] an examiner will review the entity's contracts for services to determine if various activities generate exempt or nonexempt function income.[127]

In the context of examinations of tax-exempt organizations that conduct gaming activities,[128] the IRS's exempt organizations examination guidelines state that the following factors in a management or operating agreement may indicate the presence of private inurement or private benefit: (1) the contract is lengthy in duration, (2) the contract provides for penalties if the exempt organization terminates the agreement, and/or (3) the gaming operator was not selected through open bidding or the organization lacks documentation to support such a claim.[129] Indeed, in this context, it is written that a sublease is sometimes used as a mechanism for diverting funds from an exempt organization.[130]

(i) Conflict-of-Interest Policy

Tax-exempt organizations should adopt and adhere to a conflict-of-interest policy. While generally not required as a matter of law,[131] the existence of this type of policy signals to revenue agents that the organization is ''interested in high-integrity operations and helps establish a boundary between personal and institutional interests for [the] board and employees.''[132]

[120]See App. C § I N.
[121]IRM 4.76.16.6.1.1 § 8.
[122]See App. C § I P.
[123]IRM 4.76.18.3.2.1 § 3.
[124]See App. C § I X.
[125]IRM 4.76.26.8.4 § 3.
[126]See App. C § I BB.
[127]IRM 4.76.30.3A.
[128]See App. C § XII A.
[129]IRM 4.76.50.10 § 4.
[130]*Id*. § 5.
[131]See *Tax-Exempt Organizations* § 5.6(f); *Tax-Exempt Healthcare Organizations* § 4.10.
[132]''How to Deal with IRS Audits,'' at 60.

Indeed, in the IRS's tax-exempt organizations' examination guidelines,[133] it is written that the board of directors of an exempt charter school ''should have a conflict of interest policy requiring members to disclose all financial interests they have in any service provided to the school.''[134]

(j) Other Documents

Other documents may be added to this inventory. Documents that please IRS revenue agents are codes of ethics, document retention policies, whistleblower protection policies, insurance policies (usually), consultants' reports, and appraisals (where appropriate). If the organization is a member of a partnership or other joint venture, the appropriate documentation will be reviewed. An examiner may review reports concerning an exempt organization issued by or filed with a federal, state, or local government agency.[135] Many other types of documents are likely to come under the examiner's scrutiny.

Here are some pertinent illustrations:

- In the case of an exempt charitable organization, an examiner will check supplier invoices for evidence of overbilling (looking for excess amounts used for political campaign purposes[136]).[137]
- In the case of an exempt private school (including one operated by a church[138]), an examiner will review various documents (including student application forms) to determine if the school has the requisite policy as to nondiscrimination against students.[139]
- In the case of an exempt private school, an examiner may review representative copies of all materials used to solicit contributions during a particular period.[140]
- In the case of an exempt scientific organization,[141] an examiner may review its catalogue of the organization's projects or plans to determine the types of research in which the organization engages.[142]

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[133]See Chapter 7.

[134]IRM 4.76.8.8.2 § 3B. Again (see *supra* note 108), it is not known why charter schools are singled out in this regard.

[135]For example, IRM 4.76.8.6 § 3H (concerning examinations of private schools (see App. C § I D)); 4.76.50.2 §§ 5, 6 (concerning examinations of organizations engaging in gaming activities (see App. C § XII A)).

[136]See App. C § IV.

[137]IRM 4.76.3.13.3 § 1F.

[138]See Chapter 6.

[139]IRM 4.76.7.15.1 § 2A, IRM 4.76.8.6 § 29. See App. C § I D.

[140]IRM 4.76.7.15.1 § 2H.

[141]See App. C § I G.

[142]IRM 4.76.12.2.1 § 1.

- In the case of an exempt amateur athletic sport organization,[143] an examiner will review the organization's brochures to determine if the organization links to national or international competition.[144]
- In the case of an exempt labor organization,[145] an examiner will check the dues solicitations to verify whether they contain the requisite statement as to nondeductibility of contributions.[146]
- In the case of an exempt agricultural or horticultural organization,[147] an examiner will review the organization's membership solicitation materials to identify any benefits provided to members.[148]
- In the case of an exempt business league,[149] an examiner will review the organization's membership list to ensure that the membership does not represent only a segment of a line of business.[150]
- In the case of an exempt business league, an examiner will review the organization's employee handbook for information about the organization's expense reimbursement policy.[151]
- In the case of an exempt social club,[152] an examiner will review the organization's policy statements to determine whether there are any provisions limiting membership on the basis of race, color, or religion.[153]
- In the case of an exempt social club, an examiner will review the club's handbook to determine if members have the requisite opportunity for fellowship, commingling, or other personal contact.[154]
- In the case of an exempt social club, an examiner will review the club's liquor and gaming license(s) to detect any services provided to the public.[155]
- In the case of an exempt homeowners' association,[156] an examiner will read the covenants to determine if the association is performing exterior maintenance on private dwellings.[157]

[143]See App. C § I H.
[144]IRM 4.76.12.3.2 § 1.
[145]See App. C § I K.
[146]IRM 4.76.14.3.1.1 § 5. See App. C § XIV D.
[147]See App. C § I L.
[148]IRM 4.76.14.4.2.1 § 2.
[149]See App. C § I M.
[150]IRM 4.76.15.3.1 § 3.
[151]IRM 4.76.15.6.1 § 3.
[152]See App. C § I N.
[153]IRM 4.76.16.4.1 § 1 C.
[154]IRM 4.76.16.5.1 § 2.
[155]IRM 4.76.16.6.1.1 §§ 5, 6.
[156]See App. C § I FF.
[157]IRM 4.76.13.7.1 § 3.

- In the case of an exempt fraternal organization operating under the lodge system,[158] an examiner will review reports submitted to the parent organization by its subordinate lodges.[159]
- In the case of an exempt voluntary employees' beneficiary association,[160] an examiner will review the entity's enrollment forms and membership records to verify that membership is voluntary, at least 90 percent of the membership consists of employees, and the requisite employment-related common bond is being shared.[161]
- In the case of an exempt voluntary employees' beneficiary association, an examiner will review the entity's plan documents to determine if impermissible benefits are being provided and to verify that the plans are nondiscriminatory as to eligibility and benefits.[162]
- In the case of an exempt cemetery company,[163] an examiner will review pamphlets and brochures to determine what the organization is offering for sale, and stock certificates to determine if the organization is paying dividends.[164]
- In the case of an exempt supplemental unemployment benefit trust,[165] an examiner will survey claims filed to determine whether the plan is providing impermissible benefits.[166]
- In the case of an exempt veterans' organization,[167] an examiner will review the organization's membership cards and lists to verify designation of status of individuals as veterans, non-veterans, members of an auxiliary, and other member status.[168]
- In the case of an exempt veterans' organization, an examiner will inquire as to the existence of any advertisements that may be indicative of nonexempt activities (unrelated businesses).[169]
- In the case of an exempt political organization,[170] an examiner will peruse brochures, flyers, and similar documents to determine whether various activities are productive of exempt function income.[171]

[158]See App. C § I O.
[159]IRM 4.76.17.3.1 § 3.
[160]See App. C § I P.
[161]IRM 4.76.18.3.3.1.
[162]IRM 4.76.18.3.4.1 § 1A, 4.76.18.3.5 § 3 (an employee census will also be reviewed).
[163]See App. C § I S.
[164]IRM 4.76.21.4.1 §§ 2, 3.
[165]See App. C § I W.
[166]IRM 4.76.25.3.1 § 2.
[167]See App. C § I X.
[168]IRM 4.76.26.4.2 § 1 C.
[169]IRM 4.76.26.8.4 § 3.
[170]See App. C § I BB.
[171]IRM 4.76.30.3.2.1 § 3.

- In the case of a charitable remainder trust,[172] an examiner will determine whether a ''reasonable and accurate'' appraisal[173] was made of property transferred to the trust.[174]
- In the case of an exempt organization conducting gaming activities,[175] an examiner may secure a legal opinion from a state or local law enforcement agency to determine if the gaming operation is a violation of law.[176]
- In the case of an exempt charitable organization conducting fundraising,[177] an examiner will inspect tickets or receipts issued to donors to ascertain if the organization has clearly and properly differentiated between the gift and nongift portions.[178]

(k) Review Web Site

Web site content is ''often developed by well-intentioned subject matter experts or marketing people without regard to potential tax [law] implications of the information.''[179] A tax-exempt organization should periodically review its web site with the federal tax law perspective in mind. If the organization is selected for an audit, it should be assumed that the IRS has visited or will visit the site.[180]

The following serves as illustrations of what the IRS will be looking for in this regard should there be an examination:

- In the case of an exempt business league,[181] an examiner will check the organization's web site for advertising and other indicia of unrelated trade or business activities.[182]
- In the case of an exempt organization that engaged in fundraising by means of the Internet,[183] the examiner will visit the site to identify the fundraising activities, determine if the organization is selling advertising or acknowledging donors,[184] determine the taxability of

[172]See App. C § XIII D.
[173]See *id*. § XIV E.
[174]IRM 4.76.5.1.5.
[175]See App. C § XII A.
[176]IRM 4.7650.8.1 § 4A (concerning bingo games).
[177]See App. C § XIV.
[178]IRM 4.76.51.3.1 § 4. An expert in this area offered this caution: ''Critical areas where outside documentation may be important (e.g., legal opinions, financial audits, compensation analyses) should be anticipated, obtained, reviewed and revised if necessary, and retained in a manner so that the attorney–client communication privilege and other protections can be maintained'' (''Dealing with the IRS,'' at iii).
[179]''How to Deal with IRS Audits,'' at 60.
[180]In general, see *Internet Communications Law*.
[181]See App. C § IM.
[182]IRM 4.76.15.5.1 § 3.
[183]See *Internet Communications Law*, Chapter 4.
[184]See App. C § XIV B.

any merchandise sales on the Internet, and verify that it is complying with all applicable disclosure requirements.[185]

(l) Employment Taxes

Tax-exempt organizations with employees are exposed to examination by IRS employment tax agents, in addition to exempt organizations agents.[186] These organizations should stay current with the withholding and reporting requirements, periodically review the employee/independent contractor classification of its workers, and be certain that its files contain adequate justification for independent contractor status.[187] For example, the IRS's tax-exempt organizations examination guidelines include considerable inquiry as to the compliance by social clubs with this body of law.[188]

(m) Media Coverage

Not every tax-exempt organization should have, or can afford, a media consultant. Nonetheless, an exempt organization should do what it can to get favorable publicity. Also, an exempt organization should maintain a file of newspaper articles and other forms of media coverage about it, particularly if the reports are favorable.

Here are some examples of IRS consideration of media:

- In the case of a charitable organization,[189] an examiner will peruse local newspapers looking for instances of political campaign involvement by the organization.[190]
- In the case of a private school, an examiner will determine whether it has published notices in one or more newspapers as to its policy of nondiscrimination as to students.[191]

(n) Testaments

Some tax-exempt organizations operate programs that generate letters and other forms of comment about these activities from program beneficiaries

[185]IRM 4.76.51.8.1. One expert observed: ''The new IRS enforcement tool is the Internet. Until very recently, the IRS was unwilling to allow agents to use the Internet for fear of hackers gaining access to IRS tax records. The IRS seems to have solved these concerns, since it now uses the Internet to search for news media reports of wrongdoing by charities and other exempt organizations. The IRS staff is well aware of the news media reports from around the country on alleged abuses with trustee and officer compensation and benefits.'' (''IRS Audit Techniques,'' at 1).

[186]See App. C § XII B.

[187]''How to Deal with IRS Audits,'' at 59–61.

[188]IRM 4.76.17.8.

[189]See App. C § I B.

[190]IRM 4.76.3.13.3 § 1D. See App. C § IV A.

[191]IRM 4.76.8.6 § 12. See App. C § I D.

and perhaps others. Organizations should maintain a file of these documents, again, particularly if they are favorable.

(o) Governance

Traditionally, the matter of corporate governance for charitable and other tax-exempt organizations has been nearly exclusively a matter of state law, embodied largely in state nonprofit corporation acts and principles of fiduciary responsibility. In recent years, however, law concerning exempt organization governance is emerging at the federal level, including the federal tax law. The impetus for expansion of this aspect of the law is, in part, scandals in the charitable sector and enactment of corporate governance legislation pertaining to for-profit corporations.[192]

Today the IRS is pushing to ligate tax-exempt organizations governance principles and compliance by these organizations with the law of tax-exempt organizations. A significant development in this regard occurred in mid-2007, when Steven T. Miller, Commissioner of TE/GE, in an intriguing speech, focused on various ''powerful and persistent forces'' that are shaping today's nonprofit sector and are potentially causing the IRS to ''significantly change or modify'' the agency's approach to the sector.[193]

On this occasion, the Commissioner suggested two new ''pillars'' for the IRS's exempt organizations efforts, one of which is promotion of ''standards of good governance, management and accountability.'' He asserted the case for intertwining of the matter of governance and tax-exempt organizations' compliance with the law: A ''well-governed organization is more likely to be compliant [with the law], while poor governance can easily lead an exempt organization into trouble.'' He spoke, for example, of an ''engaged, informed, and independent board of directors accountable to the community [the exempt organization] serves.''[194]

The Commissioner revealed that he is pondering this question of ''whether it would benefit the public and the tax-exempt sector to require organizations to adopt and follow recognized principles of good governance.'' He is contemplating whether the IRS can make a ''meaningful contribution'' in this area by ''going beyond its traditional spheres of activity'' by asking the exempt organizations community to meet ''accepted standards of good governance.'' He concluded these remarks by contending that there is a ''vacuum'' that needs to be filled in the realm of education on ''basic standards and practices

[192]See *Tax-Exempt Organizations*, Chapter 5.

[193]The text of this speech, presented on April 26, 2007, is reproduced at Bureau of Nat'l Affairs, *Daily Tax Report* (no. 81), April 27, 2007, at G-7; it is summarized at 24 *Bruce R. Hopkins' Nonprofit Counsel* (no. 7) 6 (July 2007). See § 1.14.

[194]This type of governing board is not appropriate for all types of tax-exempt organizations, however, such as private foundations (see App. C § V A) and social clubs (*id*. § I N).

of good governance and accountability.'' Said the Commissioner: ''Someone needs to lead the sector on this issue. If not the IRS, then whom?''

The Commissioner, on this occasion, curiously did not mention the IRS's draft of ''good governance practices'' for charitable organizations, unveiled earlier in the year. These practices concern the composition and functioning of boards of directors of these organizations, mission statements, codes of ethics, whistleblower policies, due-diligence exercises, transparency, fundraising policies, financial audits, compensation practices, and document retention policies. The IRS suggests that charitable organizations review and understand these principles to help ensure that directors understand their roles and responsibilities, and actively promote good governance practices. While adoption of a particular practice is not a requirement for tax exemption, the agency believes that an organization that adopts some or all of these practices is more likely to be successful in pursuing its exempt purposes and earning public support.[195]

The fact is that there are no uniform or generally ''recognized principles of good governance.'' There are many statements of these principles, some better than others.[196] The principles that Congress has authored include the following responsibilities of a ''governance and strategic oversight'' board:

- Review and approve the organization's mission statement.
- Approve and oversee the organization's strategic plan and maintain strategic oversight of operational matters.
- Select, evaluate, and determine the level of compensation of the organization's chief executive officer.
- Evaluate the performance and establish the compensation of the senior leadership team and provide for management succession.
- Oversee the financial reporting and audit process, internal controls, and compliance with the law.
- Hold management accountable for performance.
- Provide oversight of the financial stability of the organization.
- Ensure the inclusiveness and diversity of the organization.
- Provide oversight of the protection of the brand of the organization.
- Assist with fundraising on behalf of the organization.[197]

[195]App. B is a summary of these proposed ''Good Governance Practices,'' made public on February 2, 2007.

[196]See *Tax-Exempt Organizations* § 5.6 for a summary of them.

[197]American National Red Cross Governance Modernization Act of 2007 § 2(a)(5) (Pub. L. No. 110-26, 110th Cong., 1st Sess. (2007). This legislation contains the following ''sense of Congress'': (1) ''charitable organizations are an indispensable part of American society, but these

A related issue is whether the IRS should develop principles of tax-exempt organizations' corporate governance or advocate adherence to standards promulgated elsewhere.[198] Moreover, the most controversial element of all of this is whether good governance and accountability standards should be guidelines or law, and, if the latter, whether Congress or the IRS should articulate them. While these unresolved issues swirl about, the matter of corporate governance is seeping into the IRS's audit mindset. Appropriately or not, IRS examiners will look at exempt organizations' operations from this perspective (including, most particularly, the IRS's proposed good governance principles), focusing on the composition and functioning of boards of directors, financial accountability, transparency, conflicts-of-interest, and the like.[199] Even without much law to guide it, the prudent tax-exempt organization will review its governance structure and function to be certain it is in the best possible position in this regard should the IRS examine it.

(p) Legal Audit

The foregoing pre-audit precautions are the minimum. The tax-exempt organization that wants to do all it can to avoid an audit or to smooth the process once enmeshed in one should engage the services of a lawyer to conduct a full legal audit.[200]

§ 3.2 WINNING AUDIT LOTTERY: INITIAL STEPS AND REACTIONS

The following steps should be understood by a tax-exempt organization ''to help get through the [examination] process as painlessly as possible,''[201] once a notice of an audit has been received. In general, the examination will have been launched because the IRS selected one or more returns of the organization for review.[202]

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organizations can only fulfill their important roles by maintaining the trust of the American public,'' (2) ''trust is fostered by effective governance and transparency,'' and (3) ''Federal and State action play an important role in ensuring effective governance and transparency by setting standards, rooting out violations, and informing the public'' (*id*. § 2(b)).

[198]In a letter to the Secretary of the Treasury, dated May 29, 2007, Senate Finance Committee Chairman Max Baucus and Ranking Member Charles Grassley wrote that the ''work of the BBB Wise Giving Alliance and the Panel on the Nonprofit Sector can serve as a useful guide to the IRS in this area,'' thus suggesting that the IRS not develop its own good governance principles (see 24 *Bruce R. Hopkins' Nonprofit Counsel* (no. 9) 5, 6 (Sep. 2007)).

[199]See, e.g., § 5.18(d) (a summary of the IRS's approach to evaluating the existence and effectiveness of a tax-exempt organization's *internal controls*).

[200]See *Planning Guide*, Chapter 12.

[201]*Id*. at 61. Also ''Standing Toe-to-Toe with the IRS,'' at 136–137.

[202]See § 5.2.

(a) Telephone Call

The current practice of the IRS, in connection with a typical field examination[203] of a tax-exempt organization, is to commence the process with a telephone call—the *initial contact*.[204] (Many executives of exempt organizations find this approach unduly surprising and rather unnerving, preferring to get the news by means of a letter.[205]) The caller will, of course, announce that the organization has been selected for an examination.[206] The calling IRS representative will also advise the organization of the year or years to be covered by the examination and attempt to set the date for the preexamination conference.[207]

(b) Notice of Examination

This telephone call will be followed up with a letter from the IRS that serves as a formal notice of the examination. This letter (likely bearing the same date as the day of the telephone call) generally will contain the items referenced earlier[208] that are specific to the case.

(c) Documents Requested

The initial IDR[209] is likely to divide the documents requested into three categories: organizational documents, operational documents, and certain books and records.

(i) Organizational Documents. This IDR will undoubtedly request the exempt organization's organizing document (such as the articles of incorporation), bylaws or similar document(s), the determination letter issued to the organization recognizing its tax-exempt status, the application for recognition of exemption, and the minutes of the organization's governing body for the year preceding the first year of the audit period, for the year(s) of the audit period, and for the year immediately succeeding the audit period.

(ii) Operational Documents. This IDR will undoubtedly request the exempt organization's annual information return for the year preceding the first year of the audit period, for the year(s) of the audit period, and for the year

[203]See § 1.6(a).
[204]See § 5.18(a)(i).
[205]The notice of examination (see § 3.7(i)) is likely to reflect this fact (albeit in an understated manner), stating that ''[w]e realize some organizations may be concerned about an examination of their returns.''
[206]Usually (and technically) the IRS will state that one or more returns have been selected for examination.
[207]See § 5.18(a)(iii).
[208]See § 3.7(i).
[209]See § 5.18(a)(v).

immediately succeeding the audit period; the income tax return(s) filed by one or more individuals associated with the organization for the audit period; printed materials used to promote the organization's activities; and contracts to which the organization was a party during the audit period.

(iii) Books and Records. This IDR will probably request bank statements for all accounts (checking, savings, investments), canceled checks and deposit slips, check register, general ledger, and documentation in support of expenses claimed.

(d) Get Organized

Having received the opening telephone call from one or more IRS revenue agents, and the initial contact letter from the IRS scheduling a meeting with one or more of these agents and including an information document request, the tax-exempt organization should select a team that will be charged with overseeing the examination. The goals in this regard are to ''maximize [the organization's] control over the situation and move the agent(s) through the examination process as quickly as possible.''[210]

(e) Contact Person

The tax-exempt organization facing an IRS audit should designate an individual to be the single point of contact for the examination; from the standpoint of the IRS, the examiner will be expecting communication with such an individual.[211] The organization should endeavor to ''control contact with the IRS so that all requests for documents and/or interviews can be tracked and timely responses are made.''[212] This individual should be responsible for maintenance of a log of information document requests issued by the IRS.

(f) Communications Strategy

The IRS is likely to contact third parties, such as the exempt organization's bank, contractors, and others with whom it does business. This can lead to media attention. The organization should be ''ready with a thoughtful, considered statement for the local [and/or other] media, just in case, particularly if [the organization] already make[s] good copy for local [and/or other] reporters.''[213]

(g) Know the Cast

It is important that the tax-exempt organization know who from the IRS is involved in the audit. The appropriate representative(s) of the exempt

[210]''How to Deal with IRS Audits,'' at 61.
[211]See § 5.18(a)(ii).
[212]*Id*. at 61–62.
[213]*Id*. at 62.

organization should meet, greet, and record the name(s) of the revenue agent(s) involved, as well as of the case manager (or, at least, procure the manager's name and contact information). The organization should determine if the office of IRS Chief Counsel will be assisting the revenue agent(s). Likewise, the organization should ascertain whether one or more specialists, such as engineers, computer audit specialists, or financial analysts, are being assigned to the case.

Large, complex tax-exempt organizations may find that one or more IRS agents involved in their examinations are from the Financial Investigative Unit, which consists of more experienced agents trained in forensic accounting.[214] This expert advised on this point as follows: ''Look closely at the business card of the revenue agent and if it says 'financial investigative unit,' you should be ready to produce an awful lot of books and records, be ready to produce executives to be interviewed, and expect pretty well-crafted information document requests. You will feel like you're having a real audit.''[215]

(h) Office Facilities for IRS

The IRS may expect workspace in the tax-exempt organization's premises; this is likely to be the case only in connection with a *large case examination* or a *team examination*.[216] The request for office facilities in connection with an examination will probably be framed as follows:

3 desks/tables with chairs
3 extra chairs
2 telephones (4 lines for agents; 2 analog phone lines for computers)
1 file cabinet (5-drawer) with lock
Access to photocopier
Space and power supply for an onsite desktop computer, printer, and fax machine
The above furniture and equipment are needed until completion of the examination.
IRS workroom with locking door. Access to this space will be limited to IRS personnel. The [exempt organization] may keep a key for use in emergencies but access to the key should be restricted.

This matter of the IRS work facilities on the tax-exempt organization's premises is often a matter of some tension: The agent(s) need ''[d]ecent quiet

[214]This unit, headquartered in St. Paul, Minnesota, and Denver, Colorado, was created to support the IRS's Criminal Investigation Division, particularly in connection with cases involving potential funding of terrorism, but because of a decline in these cases, agents from this unit are becoming more routinely deployed to assist in exempt organizations audits (apparently particularly where compensation is an issue).

[215]''Attorney Says Nonprofits Should Prepare for Visit from Financial Investigative Unit,'' Bureau of Nat'l Affairs, *Daily Tax Report* (no. 41), March 2, 2007, at G-4.

[216]See § 1.6(c).

space, a telephone, [and] a place to hook up a computer.''[217] Do not stick the revenue agents in an airless, windowless room, with a light bulb hanging from a cord and a staff person chain-smoking cigars. At the same time, for obvious reasons, the organization does not want to make the revenue agents unduly comfortable. ''[L]et's be blunt—it's better to have them across the street or down the road than next door to [the organization's] lunch room.''[218] On that note, again, for obvious reasons, the organization should exercise caution, inasmuch as the IRS auditing agents have a tendency to engage exempt organizations' employees in casual conversation as a means of collecting information.

(i) Initial and Other Interviews

The initial interview[219] is likely to be a crucial step, for both parties, in the examination process. If all goes according to IRS procedures, the examiner will have carefully prepared for this meeting.[220] Needless to say, the tax-exempt organization should be prepared as well; this entails at least three elements: (1) appropriate preparation, by the lawyer or other professional who is guiding the organization through the audit, of the individual(s) who are to be interviewed by the IRS; (2) availability of all of the documents requested by the IRS or an explanation as to why one or more documents will not or cannot[221] be provided; and (3) suitable tidying and spiffing up of the office premises and the potential interviewees.

The tax-exempt organization's representative(s) should not hesitate to ask questions up front. One such question (which may not be answered) is whether the examination is part of a market segment study[222] or triggered by a particular event or issue.[223] Another is whether the agent has any special areas of interest to explore. The agent may be asked whether there is an examination plan and a tentative timetable that can be shared with the exempt organization.

Thereafter, the IRS may conduct additional interviews with the same individual or interview others. All of this is likely to be done in conjunction with document reviews, tours, and other IRS examination techniques.[224]

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[217] ''How to Deal with IRS Audits,'' at 62.

[218] *Id*.

[219] See § 5.18(g).

[220] See § 5.18(a)(vi), which includes a list of the questions the examiner is likely to ask.

[221] At the outset of a case in which your author represented a private family foundation selected for an IRS audit, where the office of the foundation was in the family home, the initial interview became somewhat constrained when the trustee that appeared for the interview explained to the examiner that the family home had recently been burgled and the robber made off with all of the foundation's books, records, and other documents; the IRS agent was visibly skeptical.

[222] See § 4.2.

[223] See § 1.2.

[224] See § 5.18(f). Also § 5.19(l) (concerning *issue development*).

(j) First Impressions

First impressions are important; the tax-exempt organization's representative(s) should be, in addition to polite, relatively talkative (albeit carefully). An overview of the organization's programs should be provided. This presentation should not be ''overly fluffy,'' yet the organization wants the agent(s) ''to understand, as soon as possible, that [it does] good works.''[225]

§ 3.3 AUDIT UNFOLDS: ONGOING STEPS

Once the IRS audit is underway, other ongoing steps are in order:[226]

(a) Documents

The tax-exempt organization under audit wants the IRS to state its requests for documents in writing. Some agents will make such a request verbally; a polite response seeking a written request for the documents is always in order. Also, the organization should not ''read more into their requests than they've specifically stated.''[227] That is, almost always, the exempt organization should not provide any more information in response to a document or other information request than what the request literally requires. Further, ''[r]emember to note the specific tax year involved in each request.''[228]

(b) Stay Calm, Things Take Time

A lawyer involved in IRS audits has offered this advice: ''The agent(s) won't have the final say in the outcome unless you agree to let them.'' (Unfortunately, however, this statement will not always mirror reality.) The organization has ''rights to explanations, conferences and a review of the agent(s) findings.'' The organization should not be afraid to exercise those rights; doing so ''doesn't count against'' it.[229]

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[225]''How to Deal with IRS Audits,'' at 63. A lawyer noted that the ''most important attribute'' a tax-exempt organization has in the context of an IRS audit is its ''credibility'' (''Dealing with the IRS,'' at v).

[226]Also ''Standing Toe-to-Toe with the IRS,'' at 137–138.

[227]*Id*.

[228]*Id*. Revenue agents today have a tendency to request documents that pertain to tax years that are not under examination, such as minutes of meetings of an organization's board of directors.

[229]''How to Deal with IRS Audits,'' at 63. A lawyer observed that the ''natural inclination'' of the IRS is to seek dispute resolution ''on an issue-by-issue basis'' (or, as he further put it, ''cherry pick''), while the exempt organization's natural inclination is to wait until there is a ''neatly wrapped, all-inclusive package [of resolved issues] at the conclusion of the audit'' (or, as he further put it, have a ''final showdown'' in an effort to play ''Let's Make a Deal''); he noted that, ''in reality, neither approach works, except in the most simplistic circumstances'' (''Handling Controversies with the IRS,'' at 3). Another lawyer more broadly advised: ''Don't panic and don't evidence anxiety'' (''Dealing with the IRS,'' at v).

(c) Audit Outcomes

Many examinations of tax-exempt organizations are focused on the organizations' eligibility for ongoing tax-exempt status. In some instances where tax exemption is on the line, a proposed revocation of exemption may be retroactive. Here are the possible outcomes in this regard:

- Retention of tax exemption (no-change letter)
- Retention of exemption (no-change letter accompanied by an advisory letter)
- Modification of exempt status (from one category of exempt organization to another)[230]
- Revocation of exemption prospectively
- Revocation of exemption retroactively

If the issue is the organization's public charity/private foundation status, the outcomes are the following:

- Loss of public charity status
- Conversion from one category of public charity to another
- Conversion from private foundation to public charity
- Conversion from nonoperating private foundation to operating foundation status
- Conversion from operating foundation to nonoperating foundation status

Other issues that may be involved, either alone or in addition to the foregoing, are unrelated business income issues, excise tax liability, and/or one or more claims.[231]

(d) Perspective

As is the case with so much surrounding the law and its compliance, the only individual(s) enjoying an IRS audit will be the lawyer(s) and/or other professional(s) advising and counseling the tax-exempt organization through the examination process. Nonetheless, although ''IRS examinations are worrisome [and] time/resource consuming,'' they are ''ultimately survivable.''[232]

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[230]This option is unavailable where the organization has recognition of exemption as an organization described in IRC § 501(c)(3).

[231]In general, see §§ 5.32, 5.33.

[232]*Id.* As one experienced lawyer observed, the ''keys to audit survival are documentation and adherence to legal advice'' (''IRS Audit Techniques,'' at 2).

§ 3.4 POWER OF ATTORNEY

If a tax-exempt organization is to be represented in the course of an IRS audit (and/or in other circumstances involving the agency) by a lawyer or other agent, the organization must file a power of attorney with the IRS, specifically authorizing the lawyer or other agent to represent the organization. (Only individuals may be named as representatives.) Generally, the filing of the agency's form ''Power of Attorney and Declaration of Representative'' (Form 2848) authorizes this power of attorney relationship. This authorization of a qualifying representative allows that individual to receive and inspect the exempt organization's confidential tax information.[233]

In general, individuals who are eligible to practice before the IRS are lawyers,[234] certified public accountants, enrolled agents, officers, full-time employees, family members, enrolled actuaries, and unenrolled return preparers (in limited circumstances). In the tax-exempt organizations context, the representative(s) is likely to be a lawyer, accountant, or officer. Lawyers and accountants are required to enter on the power of attorney the state or states in which they are admitted to practice.[235]

This power of attorney authorizes the representative to perform any acts that the tax-exempt organization can perform, such as signing consents extending the time to assess tax,[236] recording an interview, or executing waivers agreeing to a tax adjustment. Also, an organization may authorize its representative to substitute another representative or delegate authority to another representative.[237] (Authorization of a person pursuant to a power of attorney does not relieve an exempt organization of its tax law obligations.)

The IRS power of attorney form is relatively straightforward as to its preparation.[238] Notable aspects of the form are that each representative must have and use a Centralized Access Facilities (CAF) number,[239] future tax periods may be included on the power for up to three years, if there are two or more representatives on a power the predilection of the IRS is to communicate by telephone with only the first individual on the list (although the others

[233]If an organization wants to authorize an individual or organization to receive or inspect confidential tax return information but does not want to authorize that individual or organization to represent it before the IRS, the form to be filed is Form 8821.

[234]The IRS uses the term *attorney*, not *lawyer*, in this context (a member in good standing of the bar of the highest court of the jurisdiction). The word *attorney*, however, is synonymous with *representative*; hence the title of the form—power of attorney. Thus, all qualified representatives properly identified on the Form 2848 are *attorneys*.

[235]Form 2848, Part II.

[236]See § 3.11.

[237]Form 2848, Part I, line 5.

[238]The form is, nonetheless, accompanied by four pages of instructions.

[239]If a representative does not have a CAF number, the IRS will assign one when the representative first appears on a power of attorney. The IRS will not, however, assign a CAF number when the power of attorney relates to the filing of an application for recognition of exemption.

may participate once the contact is made),[240] and the filing of a power of attorney automatically revokes all earlier power(s) of attorney on file with the IRS for the same tax matters and years or periods covered by the document, unless there is an express indication that a prior power of attorney is not to be revoked.[241] As to this last point, it is common for a lawyer to be retained once notice of an IRS audit is received, even though the exempt organization is otherwise represented by a lawyer and/or another representative (such as an accountant); the power of attorney for the incoming lawyer should be prepared so that the representation by the others is not eliminated.[242]

§ 3.5 INTERACTING WITH IRS EXAMINERS

Although it is difficult (and sometimes dangerous, as to the law or otherwise) to generalize about these matters, certain personalities tend to gravitate toward certain positions of occupation or calling. Even though stereotyping is a tricky business (humans often being polymorphic), there are perceived prototypes of individuals who gravitate toward politics, firefighting, school-teaching, spying, accountancy, and so forth. (It is impossible to even attempt such a generalization about lawyers, because there are so many of them.) Entering the treacherous and parlous realm of hypothesizing about IRS agenthood, the typical agent has three characteristics: a desire to inquire and examine into matters, collect money (taxes, interest, penalties), and assert authority.

(a) Coping with Examiners

Thus, of course, when an IRS examination unfolds, one of the first orders of business, from the standpoint of the tax-exempt organization involved, is to assess—or attempt to assess—the personality of the IRS examiner or examiners involved. Initially and superficially, this can produce great variances, such as from nice to rude, quiet to assertive. As this minuet gets under way, those representing the exempt organization should never forget that the agent (1) also is positioning himself or herself, assaying the personalities of these representatives, trying to determine if these people are going to be cooperative or disingenuous, and (2) is backed up by one of the most powerful components of the federal government (obviously, the IRS).

Most often, the IRS examiner will commence the process with politeness, burnished with an air of cool assurance. This demeanor can change, of

[240]See Form 2848, Part I, line 7.

[241]*Id*., line 8. A copy of a power of attorney that is to remain in effect must be attached to the subsequent power of attorney.

[242]This is done by checking the box on Form 2848, Part I, line 8. In general, Raby & Raby, ''The Power and Responsibility of Form 2848,'' 101 *Tax Notes* (no. 7) 871 (Nov. 17, 2003).

course, from better or worse, as the examiner(s) interacts with the tax-exempt organization itself (trustees, directors, officers, employees), its representatives (such as lawyer or accountant), and perhaps third parties (such as a bank or other independent provider of goods or services). Sometimes it's bonding; other times it's combat. This element of the facts interrelates with the matter of the level of knowledge of the law of tax-exempt organizations the examiner brings to the skirmish; not surprisingly, some have more than others. The less the knowledge of the law, the greater the likelihood of bluster. Usually, the examiner will work, in a cooperative and courteous manner, with the exempt organization in developing and applying the applicable law. But, there is always the type of examiner who, having (1) taken a nonsensical position, (2) asked for authority on a point of law, and (3) been told that there is nothing specific to cite (other than common sense), retorts (this is an authentic quote): ''If you can't provide me with some precedent, then I am the authority.''[243]

This is, then, a matter of group dynamics, including at least three types of interactions involving the IRS examiner: other IRS personnel, the individual(s) comprising the tax-exempt organization, and the individual(s) representing the exempt organization. Matters thus can become more complex in this regard where there is more than one IRS employee participating in the examination. It is infrequent, but disagreement, animosity, and other forms of friction can be displayed by IRS personnel in the presence of those representing, in one capacity or another, the exempt organization. (On one memorable occasion, your author, having appeared at an audit conference where the IRS representatives were confused over the schedule and thus unprepared for the meeting, watched, with a dose of bemusement and incredulity, a tetrad of IRS employees quarrel with each other over who was at fault. Four sets of lawyers had flown in for the conference from different cities; the conference had to be rescheduled.)

The greatest amount of apprehension (from the standpoint of the tax-exempt organization under examination) and tension is likely to develop between the IRS examiner and an employee, officer, or similar proxy for the exempt organization. The IRS makes most individuals nervous, so there is no surprise in concluding that an IRS audit is a prescription for much angst for the auditee. Moreover, most executives of exempt organizations are zealous about their organization and its programs, and tend to get exercised (or upset or angry) when challenged on these fronts. Thus, when it comes to interactions between an IRS examiner and this type of representative of an exempt organization, the lawyer representing the organization generally will

[243] A lawyer advised that, at the outset, the exempt organization newly involved in an IRS audit should develop an ''overall strategy,'' deciding between ''cooperation or trench warfare.'' He also observed that the ''skill and experience of the IRS representatives, as well as the taxpayer'' [exempt organization] representatives, will have a bearing on whether disputes can be resolved. ''Handling Controversies with the IRS,'' at 3.

work assiduously with this individual in preparing him or her for the IRS interview or other interaction with the examiner and keep the communication between these individuals to a minimum. Conversely, there are some exempt organization executives, officers, and directors whose personality is such that the lawyer wants them to spend as much time with the examiner(s) as possible. Admittedly, this is a rare phenomenon, but it can happen.

If there is to be an altercation, it is likely to occur between an IRS examiner and a lawyer representing the tax-exempt organization being audited. Some of this may be pure personality clashes, but far more likely is the belief, on the part of the lawyer, that the examiner either is misconstruing one or more aspects of the law of exempt organizations or is in some fashion being unreasonable. As noted, some agents are more schooled in this area than others. Disagreement over the law does not always lead to a donnybrook but it can produce frustrations and tempers can flare. The lawyer should always strive to act civilly, but there are occasions, sometimes dictated by the exigencies of advocacy, where legal counsel needs to stand up to the examiner on matters of substantive and/or procedural law.

(b) Tours

As a general proposition, an IRS representative examining a tax-exempt organization will want, relatively early in the process, to tour the organization's facilities.[244] In some instances, of course, there will not be any facilities to tour or the facilities will consist of a few offices that are not conducive to this type of tour. The IRS examiner(s), by contrast, will almost certainly seek a tour of an exempt organization's facilities where these facilities house program activities, such as those of a school, college, university, hospital, association, large public charity, and the like. The examiner will be on the lookout for ''large, unusual, or questionable items.''[245]

These tours pose problems for tax-exempt organizations; the larger the organization, the greater the problem. Management of an exempt organization usually prefers to confine the fact of an IRS audit to as few employees as possible; a tour by the IRS spreads the news. These tours can depress employees' morale; they will assume the worst when they see the IRS prowling the premises. The biggest problem, of course, is that one or more employees of the organization will say something to an IRS examiner that is detrimental to the status of the organization.

The lawyer representing an audited tax-exempt organization should not permit one of these tours to unfold at random. The best practice is a dress rehearsal, preferably the day before the tour so that the employees involved will

[244]Indeed, pursuant to the IRS's examination guidelines, the examiner is required to request a tour and the tax-exempt organization is required to provide it. See § 5.19(a).
[245]*Id*.

have the lawyer's instructions fresh in their minds when the IRS examiner(s) appear. The route of the tour should be mapped out in advance; this needs to be carefully done, because if the tour path is obviously short, the examiner will want to wander through areas that are in plain sight. The employees whose offices are on the tour route need to be carefully counseled as to what to say and what not to say. Ideally, these individuals will be well dressed (at least on the day of the tour), polite (same), will answer questions put to them by the IRS examiner, assuming they know the answer, and will confine their responses to the scope of the questions and volunteer nothing. In short, these employees should be given a quick course in how to function as witnesses. The lawyer may want to designate one of his or her colleagues to play the role of an examiner and execute one, two, or more rehearsals of the tour, to be certain of the route and the demeanor and statements of the employees. Much can go wrong on the tour; good preparation includes making the premises (and the employees) as attractive and looking as well organized and operated as possible, and schooling the employees to say as little as possible (without being too obvious about it).

Tour participants should include, in addition to the IRS examiner(s), one executive of the exempt organization and one lawyer representing the organization. The executive should choreograph the tour, leading the agents, pointing out the significant physical features of the premises (such as departments), and stopping at the desks of the most important (and trustworthy) of the employees. The lawyer should be poised to intervene should an employee start imparting information that is not conducive to the exempt organization's cause. Here is where a blurt or a blunder is most likely; all involved on behalf of the exempt organization should be cautious and on high alert (without appearing so). The plan (and hope) should be to conclude the tour as soon as reasonably possible, without providing any information to the IRS that is deleterious to the exempt organization's tax status or liability, and with minimal disruption to the operations of the organization and the mood of the staff.

(c) Point Person

It is important to reiterate that it is highly desirable that a tax-exempt organization, having learned that it is under an IRS audit, select an individual to represent it in its interactions with the IRS.[246] This is the only individual (other than independent professionals) who will communicate with the IRS, by letter, telephone, e-mail, in-person discussions, and the like (except for formal interviews). Who this individual is will vary from organization to organization; it may be the executive director, chief financial officer, in-house counsel, a director, and so forth. The point is to have precise coordination and

[246]See § 3.2(b).

consistent communications with the IRS examiner(s) on behalf of and for the benefit of the examined exempt organization. The IRS understands and is used to this approach.

(d) Documents

During the course of a typical audit of a tax-exempt organization, the organization will provide the IRS with a considerable number of documents. It is important (such as for appeals and perhaps litigation), and a recommended management practice (if only to avoid confusion and misunderstandings), that the exempt organization retain in some organized fashion (in a file or binders) a set of copies of the documents given to the IRS. It usually also is a good practice to maintain an inventory of these documents, including the date they were provided to the IRS and the number of the information document request (IDR) in response to which each document was provided. It is usually advisable (when appropriate) to maintain two types of inventories: an inventory of documents provided to the IRS and an inventory of documents copied by (or for) and retained by the IRS.

§ 3.6 DOCUMENTS LIKELY TO BE REQUESTED

Many variables are associated with an IRS examination of tax-exempt organizations. There are, however, some constants and one of these is the range of documents that will be requested. The purpose of a typical IRS audit of an exempt organization is to substantiate the nature of the program and other activities of the organization, verify the accuracy of one or more returns, determine that all required returns have been filed, and ascertain whether any taxes due have been paid. To this end, the IRS will examine the *books and records* of the exempt organization.[247] Thus, when word of an impending IRS audit reaches an exempt organization, its staff should begin assembling copies[248] of the following:

- Governing instruments, namely, articles of organization (articles of incorporation, constitution, trust agreement, declaration of trust, and the like) and bylaws[249]
- Application for recognition of exemption (if any)
- Determination letter (if any)

[247]See §§ 5.18(v), 5.19(g)(i). [4.75.11.6.6 § 1]

[248]The typical IDR will state that it is not necessary for the exempt organization to make copies of the documents requested and that, if copies are needed by the IRS, they will be requested during the examination.

[249]See § 5.19(b)(ii) for a summary of what the IRS will be looking for.

- Minutes of board, and perhaps other, meetings (during the audit period)[250]
- Publications (such as journals, newsletters, brochures, and pamphlets)[251]
- Policies (such as conflict-of-interest, document retention, and whistle-blower)
- Operating manuals
- Leases, employment, and other contracts[252]
- Audited financial report(s) and CPA management letter(s)
- Annual information returns (if any) and other required federal returns (if any)
- Rulings from and/or correspondence with the IRS

The IRS is likely to request other documents pertaining to the audit period(s). The staff of the tax-exempt organization, however, will undoubtedly want to wait to respond to one or more IDRs before making mounds of copies of them. These documents include financial records (chart of accounts, general ledger, financial statements, and other supporting documentation)[253] and correspondence files.[254] Also, the IRS may request hard copies of web site pages.[255]

§ 3.7 QUALIFIED AMENDED RETURNS

The concept of the *qualified amended return (QAR)* was originally developed in connection with the accuracy-related penalties.[256] A QAR is either an amended return or a request for an *administrative adjustment*[257] filed with the IRS after the filing of the original return and before one of a series of dates.[258] The pertinent of these dates is a date before the date the taxpayer is first contacted by the IRS concerning an examination with respect to the return. The ability to file a QAR is intended to encourage voluntary compliance, by

[250]See § 5.19(g)(iii) for a summary of what the IRS will be looking for.
[251]See § 5.19(g)(iv) for a summary of what the IRS will be looking for.
[252]See § 5.19(b)(vii) for a summary of what the IRS will be looking for.
[253]See § 5.19(b)(ix) for a summary of what the IRS will be looking for.
[254]See § 5.19(b)(viii) for a summary of what the IRS will be looking for.
[255]A representative (such as a lawyer or accountant) of a tax-exempt organization enmeshed in an IRS examination is likely to hear an executive or officer of the organization complain that the IRS has already been provided copies of many of the documents requested, usually during the process of applying for recognition of exemption. While this is true, the examining agent will be of the view that it is much easier (from the standpoint of the IRS) to secure these documents from the organization than try to locate them within the IRS.
[256]IRC § 6662.
[257]IRC § 6227.
[258]Reg. § 1.6664-2(c)(3).

according taxpayers the opportunity to avoid accuracy-related penalties by filing an amended return before the IRS learns of the misfiling and imposes the penalties or before the IRS commences an investigation of the taxpayer.

The IRS has the authority to publish a revenue procedure to apply the QAR rules to ''particular classes'' of taxpayers.[259] The IRS did so with respect to tax-exempt organizations,[260] which applied to exempt organizations selected for a *coordinated examination program (CEP)* audit. CEP audits have been discontinued; they have been replaced by the *team examination program (TEP)* audits.[261] The IRS has not updated this revenue ruling but nonetheless now applies it in the TEP setting.

A tax-exempt organization that has been selected for a TEP audit may be offered by the IRS the opportunity to file a QAR for one or more of the years involved in the audit. Despite the formal definition of the QAR, the IRS may allow the filing of the QAR in this setting, even though the IRS contact has already occurred, as long as it is filed before the date of the first meeting with the IRS.

§ 3.8 ISSUE ELEVATION

Circumstances may arise when an employee of the Tax Exempt and Government Entities Division is expected to elevate an issue, that is, bring an issue that is presented to him or her in the ordinary course of business to the attention of a higher-ranking manager or executive.[262] Likewise, a higher-ranking manager or executive of the Division may wish to inquire about an issue or a case that is being worked or awaiting decision at a lower level. Further, front-line employees and managers are to be consulted when certain practices and procedures are developed.[263] Executives and other representatives of tax-exempt organizations under examination should be aware of these procedures; these practices of the IRS may explain the involvement of certain IRS individuals at certain times during the course of the examination.

(a) Definition of *Elevation*

The term *elevation*, as used in this context, means to bring to the attention of higher-level managers or executives, for their information or decision, an issue,

[259]Reg. § 1.6664-2(c)(4)(ii)).
[260]Rev. Proc. 94-69, 1994-2 C.B. 804.
[261]See § 1.6(c).
[262]Normally, issue elevation within the TE/GE chain of command has employees elevating issues to their immediate managers who, in turn and as appropriate, elevate them to successively higher levels (IRM 1.54.1.5). A deeper comprehension of issue elevation necessitates an understanding of the TE/GE organizational structure, involving front-line employees, group managers, senior managers, and the TE/GE structure within the National Office (see § 2.3(a)).
[263]IRM 1.54.1.2.

concern, or situation about which the managers or executives must know in order to ''execute the tax law faithfully'' and to properly manage the Division. The concept is that the individual expected to elevate an issue should know that others within the Division need to know about it or that he or she is not ''authorized, experienced, or knowledgeable enough to handle or decide the issue himself or herself.'' A referral of a matter to the Office of Chief Counsel is not an elevation of an issue; it can become an elevation, however, if the power of decision over the issue is transferred to that office.[264]

(b) Definition of *Issue*

The term *issue*, as used in this context, generally means a matter that should not be decided or otherwise resolved in a routine, standard, or uniform manner; often, the matter is new, unusual, or sensitive. Ordinarily, an issue is a matter that must be decided or resolved through the use of ''careful analysis, sound judgment, discretion and experience.'' An issue may include one or more of the following:

- The interpretation or application of law or published guidance to a case
- A nonstandard case, such as unusual aspects of a determination letter application or of an open or potential examination
- Published guidance, including regulations, revenue rulings, revenue procedures, announcements, and notices
- A new administrative action or procedure, or a revision or an exception to an existing action or procedure
- The interpretation or application to a case of a new or existing administrative action or procedure
- A developing or emerging issue, including issues that have not formally been presented to the Exempt Organizations Division by a taxpayer or that have not arisen in an examination, such as an issue the IRS became aware of while attending a professional conference
- An allegation brought to the Division's attention by an outside party, such as a report in a newspaper or a letter from a member of the public, suggesting a violation of the law of tax-exempt organizations[265]

(c) Why Issues Are Elevated

A ''variety of sound business reasons suggest that many issues arising at lower levels of the [IRS] should be elevated to higher levels.'' In general, issues need to be elevated to inform managers and executives of ''things they need to

[264]IRM 1.54.1.2.1.
[265]IRM 1.54.1.2.2 § 1.

know'' and to present matters to them for decision.[266] In considering whether to elevate an issue, an individual at any level within the Division is expected to ask himself or herself the following two questions:

1. ''Am I technically capable, authorized, and comfortable about deciding this issue myself?'' If the answer to any part of this question is no or is in doubt, the individual is to elevate the issue to his or her immediate supervisor.[267]
2. ''Is this issue something that my manager, or a higher-ranking manager or executive, would want to know about or should know about in order to perform his or her duties?''

In case of doubt about whether an issue should be elevated, the ''better practice'' is to elevate it. After all, one to whom an issue is elevated may, in his or her discretion, decline the elevation and flip the matter back to the ''originating'' employee or manager.[268]

(d) Elevation to Inform Managers or Executives

Reasons to elevate an issue for the purpose of informing managers or executives include the following:

- Inform managers and executives of issues that may eventually require action, approval, or a response, or that have the potential to become problems but which will not come to managers' or executives' attention through an ''established reporting program.'' Illustrations of these issues are ''sensitive issues, high-impact cases, matters which may generate publicity, or matters which have been handled inappropriately.''
- Secure the cooperation of, or coordination with, another part of the TE/GE Division, another component of the IRS, or another government agency.

[266]IRM 1.54.1.3 § 1.

[267]In the author's experience, the examining IRS agent will be technically authorized to, and comfortable in, deciding (or at least proclaiming on) an issue. The matter thus is likely to turn on whether the individual is *capable* to (competent to) decide the issue. As a case in point, an examining agent insisted that a tax-exempt public charity must have its exemption revoked unless it reconstituted its board of directors to an ''independent'' board. Inasmuch as the federal tax law does not require this type of board (in this context), the agent was asked for some authority in support of this assertion. The response was citation to the tax regulation that references a ''governing body which represents the broad interests of the public'' (Reg. § 1.170A-9(e)(3)(v)). That regulation, however, is pertinent only in application of the facts-and-circumstances test (see *Private Foundations* § 15.4(c)); it has no bearing on the composition of governing boards of charitable organizations in general. The agent was adamant on the point; only a consultation with the agent's supervisor properly resolved the matter. Sometimes if the IRS agent will not elevate an issue, counsel for the tax-exempt organization must do it for him or her.

[268]IRM 1.54.1.3 §§ 2, 3.

- Obtain the assistance or solicit the views of the Office of Chief Counsel[269] or the Department of the Treasury.[270]
- Obtain the assistance or solicit the views of the TE/GE Senior Technical Advisor.[271]
- Obtain or promote the uniform application of the law or the achievement of uniform results.
- Recommend improved administrative practices or bring to light weaknesses in existing administrative practices.
- Notify managers and executives of deviations from established administrative practices and the reasons for the deviations.
- Bring to light a sensitive or other important issue that is ''obscured'' by procedural or other issues.[272]

(e) Elevation to Obtain Decision

Reasons to elevate an issue for the purpose of obtaining a decision[273] include the following:

- Present managers and executives with issues that require their action, approval, or response.
- Comply with a statute, regulation, procedure, or directive that specifies the level at which a particular type of decision is to be made.[274]
- Obtain a decision when the issue is one of first impression, is precedent-setting sensitive, or otherwise is of such significance that it should be decided at a higher level within the IRS.
- Obtain a decision where the correct resolution of an issue is unclear or not well established.
- Offer senior managers or executives the opportunity to concur with or dissent from the proposed resolution of an issue when the proposed resolution is ''novel, sensitive, or precedent-setting.''

[269]See § 2.2, text accompanied by note 32.
[270]See § 2.1(a).
[271]See § 2.4(a).
[272]IRM 1.54.1.3.1.
[273]This reason for issue elevation is obviously far more pertinent to a tax-exempt organization under examination than the reason summarized in § 3.8(d).
[274]For example, certain issues must be submitted for mandatory technical advice (see § 1.9); requests for relief pursuant to IRC § 7805(b) must be transmitted to the Commissioner, TE/GE (see § 1.12); closing agreements must go to the Commissioner, TE/GE, or the Director of the EO Division; and field directives require that certain cases be forwarded to specific places for decision.

- Obtain a decision where there is disagreement among employees, managers, or different components within the TE/GE Division or the IRS as to how a technical issue or an administrative issue should be resolved.
- Obtain a decision where the organizational interests of different components within the Division or the IRS are in conflict, or where an impasse has been reached because of such conflict.
- Obtain personnel, budgetary, or other resources.[275]

(f) Issues That Are Candidates for Elevation

Issues that are candidates for elevation to obtain a decision[276] are:

- Issues that require the action, approval, or response of a manager or executive
- Issues that are directed by statute, regulation, revenue procedure, or other directive or practice to a particular office or level for resolution or decision
- Issues that are of first impression, precedent-setting, or sensitive, including departures from established positions or practices[277]
- Issues in which the correct resolution is unclear or not well established
- Issues that are sensitive but the sensitivity of which is ''obscured'' by procedural or other issues
- Situations in which there is disagreement among employees, managers, or different components within TE/GE or the IRS as to how a technical issue or an administrative issue should be resolved
- Situations in which the organizational interests of different components within TE/GE or the IRS are in conflict or where an impasse exists because of the conflict
- Issues concerning personnel, budgetary, or other resources
- Situations involving the amendment or revocation of a compliance statement, or revocation of a closing agreement[278]

[275]IRM 1.54.1.3.2.

[276]Issues that are candidates for elevation to inform managers and executives are the subject of IRM 1.54.1.4 § 2.

[277]These ''departures'' are all too frequent within the IRS these days, as illustrated by abrupt and unfair changes in policy (without benefit of legislation or hearings) concerning credit counseling organizations (see *Tax-Exempt Organizations* § 7.3) and down payment assistance organizations (see *id*. § 7.5). The courts do not permit the IRS to successfully make these departures when the policies are established by regulations (at least not retroactively) (see § 1.12), but there is almost no law as to other forms of IRS policy shifts.

[278]IRM 1.54.1.4 § 3.

(g) Referral to or Consultation with Counsel

TE/GE employees and managers are required to refer to or consult with Chief Counsel in instances where legal advice is need to properly interpret and apply the federal tax law. This type of referral or consultation is often akin to issue elevation (as opposed to a formal seeking of technical advice[279]). Referral or consultation in this context is advised where the correct interpretation or application of law is uncertain or when a tax-exempt organization ''seriously challenges'' the position of the TE/GE Division with respect to an issue.[280]

The following are examples of issues that TE/GE employees are expected to bring to the attention of Counsel:

- Novel or unsettled issues of law
- Cases in which the prospect of litigation is present, whether the prospect is remote or imminent
- Cases in which referral to or consultation with Area Counsel is required by law, revenue procedure, other written directive, or practice
- Questions as to disclosure, bankruptcy, summons, and the like
- Proper implementation of new or amended provisions of the Internal Revenue Code
- Questions relating to proposed regulations, revenue procedures, announcements, notices, and other forms of technical guidance
- Resolution of technical advice cases in which novel, uncertain, or unsettled issues of law are present
- Disputes with other federal agencies[281]

In general, TE/GE employees and managers outside Washington, D.C., consult with Area Counsel that serves their ''post of duty.'' Likewise, generally, TE/GE employees and managers working in the National Office (headquarters) consult with the Washington office of Chief Counsel.[282] In most instances, when a matter is referred to or there is consultation with Counsel, employees and managers also elevate to their immediate supervisors the facts giving rise to the referral or consultation.[283]

§ 3.9 APPEALS

The appeal rights of a tax-exempt organization may vary depending on whether additional tax has been proposed. Certain appeal procedures are

[279]See § 1.9.
[280]IRM 1.54.1.7 § 1.
[281]IRM 1.54.1.7.2.
[282]IRM 1.54.1.7 §§ 2, 3.
[283]IRM 1.54.1.7.1.

available for issues resulting in additional tax. These appeal rights extend to persons subject to tax pursuant to Internal Revenue Code chapter 42, such as foundation managers. Other procedures are available for issues involving determination, revocation, or modification of an organization's exempt or public charity/private foundation status. Eventually, a tax may be charged even on an exempt status issue.

(a) IRS District Office Action

If an organization receives, from a district office of the IRS, a proposed adverse determination letter or a determination letter proposing revocation or modification of exempt status, the organization may, within 30 days from the date of the letter, appeal through the district office to the Office of the Regional Director of Appeals.[284] If an appeal is not filed within this 30-day period, the proposed adverse determination, revocation, or modification letter will become final.

An IRS district office must request technical advice from the National Office on any tax-exempt organization status issue for which there is no published precedent or for which there is reason to believe that nonuniformity exists. If an organization believes that its case is within one of these categories, it should ask the district director to request technical advice. If a determination letter is issued based on technical advice, further administrative appeal is not available on an issue that was the subject of the technical advice.

(b) Regional Office Appeal

An appeal to the Office of the Regional Director of Appeals should be filed with the appropriate district office. This appeal, in the form of a *protest*, must contain the following:

- The organization's name, address, and employer identification number
- A statement that the organization wants to appeal the determination
- The date and symbols on the determination letter
- A statement of facts supporting the organization's position as to any contested factual issue
- A statement outlining the law on which the organization is relying
- A statement as to whether a hearing is desired

Following the filing of the protest, the organization will receive a letter from an Appeals Team Manager at the appropriate Appeals Office, acknowledging receipt of the appealed case and providing contact information about the individual to whom the case has been assigned. This letter will state that

[284]See § 2.11.

Appeals is ''separate from—and independent of—the division of the Internal Revenue Service taking the action you disagree with.'' This letter will also state that what Appeals does is ''review and resolve disputes'' and ''do this in a fair and impartial manner by using the law and judicial decisions to weigh the facts.'' The letter will add that ''[w]e will try to contact you quickly.''[285]

If a hearing is requested, it will be held at the IRS regional office, unless the organization requests that the meeting be held at a district office that is convenient to both parties.

If the regional office, after considering the organization's appeal, as well as information presented in any hearing, agrees with the district office's position in whole or in part, it will notify the organization of its decision in writing, presenting a statement of the key facts, law, rationale, and conclusions for each issue contested.

The Office of Regional Director of Appeals must request technical advice from the IRS's National Office on any exempt organization status issue as to which there is no published precedent or for which there is reason to believe that nonuniformity exists. If an organization believes that its case falls within one of these categories, it should ask the Director of Appeals to request technical advice. If a determination letter is issued based on technical advice, further administrative appeal is not available on the issue that was the subject of the technical advice.

(c) Proposed Additional Tax

If, after an examination is completed, the IRS district office determines that an organization owes additional tax, an examination report will be issued explaining the reasons for the proposed adjustments. If the organization disagrees with the proposed adjustments, it has the right to appeal within the IRS, take the case to court, or both.

An organization may appeal the decision of the district office to the Office of Regional Director of Appeals. This is done by filing an appeal with the district office within 30 days from the date of the letter transmitting the examination report. This appeal should contain:

- The organization's name, address, and employer identification number
- A statement that the organization wants to appeal the findings of the district office to the Office of Regional Director of Appeals
- The date and symbols on the letter transmitting the examination report and findings that the organization is appealing

[285]In mid-2007, your author was looking at an Appeals acknowledgment letter dated May 18, 2006, in connection with an exempt organizations case as to which there had been no action in connection with the appeal by the IRS (other than to secure an extension of the statute of limitations (see § 3.11)).

- The tax periods involved
- An itemized list of the adjustments with which the organization does not agree
- A statement of facts supporting the organization's position in any contested factual issue
- A statement outlining the law on which the organization is relying
- A statement as to whether a hearing is desired

If a hearing is requested, it will be held at the regional office, unless the organization requests that the meeting be held at a district office that is convenient to both parties.

If the Office of Regional Director of Appeals, after considering the organization's appeal, as well as information presented in any hearing, agrees with the district office's position, in whole or in part, it will notify the organization of its decision, presenting a statement of the key facts, law, rationale, and conclusions for each issue contested. A notice of deficiency will be issued at this point, and, to appeal further, the organization must turn to the courts.

In situations involving both a proposed revocation or modification of a ruling or determination letter and additional tax, issuance of the notice of deficiency may be delayed pending the outcome of any request for technical advice made to the National Office on the determination, revocation, or modification issue.[286]

§ 3.10 PARADE OF IRS FORMS

An IRS examination of a tax-exempt organization is replete with the agency's forms, not all of which will be involved in every audit and some of which the exempt organizations and its representatives will never see. The executives and staff of the exempt organization are highly unlikely to have any interest in the forms per se and their numbers. The professional(s) involved in the examination, by contrast, should have intimate familiarity with these forms, to be able to effectively advise the organization and guide it through the process (and to be prepared should the unexpected happen in the shape of a question about an IRS form from the client).

Here are the forms most likely to be encountered in one of these audits:

[286]The Section of Taxation, American Bar Association, on September 19, 2007, sent a report to the IRS, based on a survey circulated to its members, concluding that, while most of the respondents believe that Appeals Officers are ''generally fair,'' there is ''agreement across a substantial component of the respondent pool with regard to perception that certain recent changes in the structure and procedures of IRS Appeals have had a negative effect on the independence or appearance of independence of Appeals.'' This report is summarized at Bureau of Nat'l Affairs, *Daily Tax Report* (no. 183), ''ABA Section of Taxation Survey Shows Many Believe IRS Appeals Independence Diminished'' (Sep. 21, 2007, at G-3).

(i) Notice of Examination. This will undoubtedly arrive prepared on the basis of an IRS form letter (Letter 3611). This letter will include the following:

- A reiteration of the fact of the examination and the period(s) to be covered by it.
- The tentative date set for the preexamination conference. The exempt organization will be asked to confirm this date by telephone; the IRS will set the time and place of the conference. Within reason, the IRS will then or subsequently agree to another time and/or place.
- Identification of the IRS personnel who will attend the conference.
- A request for identification of the personnel and/or representatives of the exempt organization who will participate in the conference.
- A reminder that, if the exempt organization is to designate an individual to represent it during the course of the examination, the requisite power of attorney (Form 2848) needs to be executed.
- An inventory of the topics the IRS would like to discuss at the conference. Depending on the type of examination, one of the topics may be what is euphemistically termed *arrangements for accommodation*, which means the availability of office space; telephone, photocopying, and other equipment; and record-storage facilities.
- A request for a letter of authority from a corporate officer empowered to bind the exempt organization.
- A request for an appropriate representative of the organization to at least, at the beginning of the examination, discuss the operations of the organization and to be available at the end of the examination to discuss the results.
- A summary of the examination procedures, including conference and appeal rights.
- Identification of the location of records.
- An invitation to the organization to discuss any subjects, topics, or problems that it may wish to share with the IRS.

This letter may state that ''[w]e examine returns to verify the correctness of income or gross receipts, deductions and credits, and to determine that the organization is operating in the manner stated and for the purpose set forth in its application for recognition of exemption.'' The IRS may attempt to assuage anxiety by observing that, ''[i]n many cases, we close examinations without changes.''[287] Yet this letter will add that ''[w]hen we complete the examination, we will explain our recommendations and how they may affect your exempt

[287]See § 5.33(a).

status or tax liability, such an unemployment, excise or unrelated business income taxes.''[288]

(ii) Information Document Requests. The proper way for the IRS to request a document from a tax-exempt organization is by means of an *information document request* (Form 4564) (IDR). (Occasionally an IRS examiner will request a document orally; this practice is to be avoided, if possible.) The examination notice letter is almost certain to be accompanied by one or more IDRs; the IRS will probably send one or more IDRs later. If an IDR is sent with this letter, the date for responding to the IDR will be stated in the letter and in the IDR. All subsequent IDRs will include a response date. The response date may be the date of the initial appointment.

An IDR will be numbered (with no limit on the number of IDRs the IRS may issue in the course of an examination), indicate the subject of the request, the individual to whom the request is being submitted, the name (and title and badge number) of the IRS requestor, and the purpose of the IDR. Some documents submitted to the IRS may not be copied.

(iii) Power of Attorney. The IRS's power of attorney form is generally Form 2848, as discussed previously.[289]

(iv) Explanation of Items. In many audits of tax-exempt organizations, the IRS's Explanation of Items (Form 886-A) will be the most important of the agency's forms. It is on this form that the IRS, in addition to identifying the exempt organization and the period covered by the examination, will write up, usually in some detail, its views as to the issues, facts, law, the organization's and government's positions, and the government's conclusion(s) as to how the case should be resolved.[290]

(v) Exempt Organizations—Report of Examination (Proposed Status Changes). Close in importance to the Explanation of Items is the IRS form that accompanies the explanation—the Report of Examination (Form 4621-A). This form will include identification of the tax-exempt organization, the period covered by the examination, the name of the preparer of the report, the name of the representative of the exempt organization with whom the findings were discussed, and an indication as to whether an agreement with the organization was secured.

Most significantly, this report will indicate the nature of the proposed change in the organization's tax law status, including the effective date of the proposal:

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[288]See § 5.33(b).
[289]See § 3.4.
[290]See § 5.35(a).

- Revocation of exemption[291]
- Modification of *foundation status*[292] from the current classification to private nonoperating foundation status
- Modification of foundation status from the current classification to operating foundation status
- Modification of foundation status to a category of public charity status[293]

(vi) Consent to Proposed Action—Section 7428. The Consent to Proposed Action form (Form 6018) is the document the IRS uses to secure (if it can) agreement from the tax-exempt organization as to the status change proposed by the IRS. This form pertains to issues that the exempt organization could litigate pursuant to the declaratory judgment procedure authorized by section 7428 of the Internal Revenue Code.[294]

(vii) Thirty-day Letter. The IRS will send the tax-exempt organization a copy of its report of examination, accompanied by a cover letter (based on IRS form Letter 3618). This letter will notify the organization that, if it does not agree with the proposed change in status, the organization is required to submit a protest within 30 days of the date of the letter. The IRS will enclose a copy of Publication 3498, which describes the examination process, and of Publication 892, which describes the appeals process. This letter also notifies the exempt organization that the matter can be referred for technical advice[295] and that the organization may contact the office of the National Taxpayer Advocate.[296]

(viii) Appeals Acknowledgment Letter. Following filing of the protest, the tax-exempt organization will receive a letter (no form number) acknowledging receipt of the case for consideration by a named Appeals Office.

(ix) Consent to Extend the Statute of Limitations. An IRS form that a tax-exempt organization is likely to receive in this process, particularly if the case goes to Appeals, is a consent to extend the statute of limitations (or, more technically, to extend the period for tax assessment) (Form 872). For example, the period for tax assessment may expire before Appeals can complete consideration of the case. This form will be accompanied by a cover

[291]This report differentiates between tax exemption on the basis of IRC § 501(c)(3) and other exemption provisions.
[292]This term also embraces *public charity status* (see App. C § V).
[293]This report differentiates between public charity status based on IRC § 509(a)(1) and other bases for public charity status. See § 5.35(d).
[294]See § 3.13(b).
[295]See § 1.9.
[296]See § 2.12.

letter (no form number) that will also enclose a copy of IRS Publication 1035, titled ''Extending the Tax Assessment Period.'' If the client consents, the Form 872 can be executed and filed by the exempt organization's representative.

§ 3.11 STATUTE OF LIMITATIONS

The federal tax law imposes time limitations on the IRS in relation to its ability to examine (or take other actions) with respect to a taxpayer; these rules of law are termed *statutes of limitation*. The general statute of limitations (as to assessment and collection of taxes) requires the IRS to act within three years—the *open years*—in connection with a taxpayer.[297] This time period generally commences—that is, the statute of limitations begins to run—with the filing of a return. Thus, in the case of a tax-exempt organization, the general statute of limitations as to examination of an annual information return is three years from the due date of the return or the date it was filed, whichever is later. In some instances, the statute of limitations in the exempt organizations context is six years.[298]

The IRS, in the course of planning and conducting an examination of a tax-exempt organization, is intensely conscious of the running of the applicable statute of limitations. The phraseology favored by the IRS is that the statute of limitations is to be *protected*.[299] IRS examiners bear the responsibility for seeing to it that the government's interests are protected by not letting the applicable statute of limitations run out before the examination, including any administrative appeal, is completed.

This concern with protection of the statute of limitations is imposed on IRS examiners at the outset, when cases are assigned. Following assignment, the examiner is expected to verify the statute of limitations date and ensure that there is ample time. Generally, an examination of an exempt organization's return will not be initiated where there is less than 12 months remaining in the statute of limitations period.[300] Thereafter, an IRS examiner may seem nearly hypervigilant about the statute of limitations as the audit process evolves. This is the case during the examination period and in the course of any ensuing appeal.

One IRS form a practitioner representing a tax-exempt organization in an audit is likely to see at least once during the examination is Form 872—the form by which a statute of limitations period is extended by the taxpayer (or the taxpayer's representative).[301] This form may easily be presented by the IRS

[297] IRC § 6501. See § 5.4(g), text accompanied by note 137.
[298] See § 5.4(g), text accompanied by notes 138–142.
[299] See § 5.4(g), text accompanied by note 129.
[300] *Id.*, text accompanied by note 131.
[301] See § 3.10(ix).

to a tax-exempt organization on two or three occasions during the course of an examination.

Conventional practice has tax-exempt organizations (and other taxpayers) acceding to IRS requests to extend the statute of limitations. Usually this extension of time is in the interests of both parties. Refusal by a taxpayer to extend a statute of limitations may be expected to result in the full panoply of available IRS wrath (in the exempt organizations context, for example, assessment of penalties and revocation of exemption), whereas an extension may well afford the parties an opportunity to reach a more favorable (at least from the standpoint of the exempt organization) outcome. Thus, extension of a statute of limitations is not necessarily merely a postponement of the inevitable. Occasionally, however, a refusal to extend a statute of limitations, in the context of an IRS audit, is the appropriate course of conduct, although, often, whether that decision is in fact correct is not known until the process has played out. In what may be the most successful—if not the most spectacular—refusal to extend a statute of limitations in the history of the law of tax-exempt organizations, the refusal led, in part, to the imploding of the IRS's case against the exempt organization (and its disqualified persons), culminating with an appellate court's reversal of the case and a rendering of a judgment in favor of the taxpayers.[302]

§ 3.12 AN UNWANTED OUTCOME

An organization, recognized as a tax-exempt charitable entity at the time, had its exempt status revoked after it submitted the following statements to the IRS:

- ''All activities of the entity are conducted for profit.''
- ''There were no activities conducted by the entity [during the audit period] which would meet the criteria of a tax-exempt function'' as a charitable organization.

[302]*Caracci v. Comm'r*, 456 F.3d 444 (5th Cir. 2006). In this case, while under audit, the taxpayers refused to consent to extension of the statute of limitations. This forced the IRS to issue statutory notices of deficiency ''based on the best available information that [the IRS] had at that point'' (at 457). In fact, the IRS needed more time to analyze the case; it thus issued what the appellate court termed ''premature notices'' (*id*.). These notices turned out to be ''excessive and erroneous'' (*id*.). Once the IRS conceded this (which it did in its opening statement at trial, nearly four years after they were issued), the trial court should have shifted the burden of proof in the case to the government (which it failed to do). This triggered a ''cascade of errors'' (at 456) by both the IRS and the trial court, resulting in a reversal of the trial court and a judgment for the taxpayers. Had the taxpayers consented to an extension of the statute of limitations, the IRS presumably would have had the time to perfect its notices of deficiency, with the outcome of the case being completely different. As one expert noted: ''One year extensions are routine; [tax-exempt organizations] and their advisors will have to debate more carefully the willingness to extend the statute beyond one additional year'' (''Dealing with the IRS,'' at vi).

- ''[I]t has become abundantly clear that it is impossible for me to defend to you or the Service that the entity is a non-profit within the meaning of [IRC § 501(c)(3)],'' inasmuch as it ''performs no charitable function for unrelated persons or groups'' and ''if it ever did meet that criteria at its inception back in the 1980s, it certainly does not meet those criteria today.''
- ''The Form 990 filed for the year in question is wrong for many reasons, most notably the idea that revenue flowing into the entity has anything to do with a tax-exempt purpose.''
- ''Its sole source of funds IS the unrelated trade or business activity that has been conducted for years'' (emphasis in original).
- ''[T]he organization over the years has evolved away from its original intended purposes and these activities are not (and could not be properly characterized as) charitable activities.''
- ''The organization's tax-exempt status will (and should be) revoked by the Service.''

The IRS agreed, not surprisingly, with this organization's assessment of the situation and revoked its tax-exempt status—retroactively.[303]

§ 3.13 LITIGATION

Generally, issues involving determination, revocation, or modification of an organization's tax-exempt status may not be appealed to a court until a tax has been proposed or paid. If the adverse determination, revocation, or modification concerns exempt and/or public charity status issues with respect to charitable organizations, a declaratory judgment procedure may be available.

The IRS may revoke an organization's tax exemption, notwithstanding an earlier recognition of its exemption by IRS ruling or court order, where the organization violates one or more of the requirements for the applicable exempt status. If the recognition of exemption was by court order, the IRS is not collaterally estopped from subsequently revoking the exemption where the ground for disqualification is different from that asserted in the prior court proceeding.[304]

If an organization's tax-exempt (or, where applicable, public charity) status is revoked (or adversely modified) by the IRS, its administrative remedies are much the same as if the original application for that status had been denied.[305]

[303]Priv. Ltr. Rul. 200646019 (May 8, 2006).
[304]*Universal Life Church, Inc. v. United States*, 86-1 U.S.T.C. ¶ 9271 (Cl. Ct. 1986).
[305]Rev. Proc. 2007-52, 2007-30 I.R.B. 222 § 12.02; *Tax-Exempt Organizations* § 23.8. The protest and conference rights before a final revocation notice is issued are not applicable to matters where

The principle of procedural due process, embodied in the Fifth Amendment to the U.S. Constitution, does not require the IRS to initiate a judicial hearing on the qualification of an organization for tax-exempt status before revoking the organization's favorable determination letter. This point was addressed by the Supreme Court in 1974.[306] It was reaffirmed nearly 20 years later, when another court found that the Supreme Court's analysis is still the law, that the revocation did not infringe on the organization's exercise of First Amendment rights,[307] and that, even if the organization had a property interest in the IRS's prior recognition of its exempt status, the revocation was not a deprivation of property without procedural due process.[308]

(a) General Rules

Facing revocation of tax-exempt status and having exhausted its administrative remedies, an organization's initial impulse may be to seek injunctive relief in the courts, to restrain the IRS from taking such action. The Anti-Injunction Act,[309] however, provides that, aside from minor exceptions, ''no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person.''[310] Despite the explicitly inflexible language of the statute, the U.S. Supreme Court carved out a narrow exception, in that a pre-enforcement injunction against tax assessment or collection may be granted only if it is clear that under no circumstances could the government ultimately prevail and if equity jurisdiction otherwise exists (i.e., a showing of irreparable injury, no adequate

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delay would be prejudicial to the interests of the IRS (such as in cases involving fraud, jeopardy, or the imminence of the expiration of the statute of limitations, or where immediate action is necessary to protect the interests of the federal government) (Rev. Proc. 2007-52, *supra* § 7.09).

[306]*Bob Jones Univ. v. Simon*, 416 U.S. 725 (1974), *aff'g* 472 F.2d 903 (4th Cir. 1973), *reh. den.*, 476 F.2d 259 (4th Cir. 1973).

[307]This argument was based on the fact that the organization involved, a charitable (IRC § 501(c)(3)) entity, has a First Amendment (free speech) right to solicit charitable contributions. See *Fundraising* § 4.3.

[308]*United Cancer Council, Inc. v. Comm'r*, 100 T.C. 162 (1993).

The church audit rules (see Chapter 6) require that a church tax examination take no more than two years to complete (*id.*, text accompanied by *infra* note 142). A federal court of appeals held that the revocation of the exempt status of a church cannot be defended against on the ground that the IRS failed to complete its audit of the church within the requisite period (*Music Square Church v. United States*, 218 F.3d 1367 (Fed. Cir. 2000)).

[309]IRC § 7421(a).

[310]The Anti-Injunction Act was held to bar a lawsuit by a tax-exempt organization against the Commissioner of Internal Revenue and other representatives of the IRS for damages for initiating an allegedly political audit against the organization (*Judicial Watch, Inc. v. Rossotti*, 2003-1 U.S.T.C. ¶ 50, 202 (4th Cir. 2003)). Also the Tax Exemption to the Declaratory Judgment Act, 28 U.S.C. § 2201. For example, *American Soc'y of Ass'n Executives v. Bentsen*, 848 F. Supp. 245 (D.D.C. 1994) (holding that both statutes deprived the court of jurisdiction over challenge of the constitutionality of the law denying the business expense deduction for dues paid to exempt associations that engaged in lobbying (see *Tax-Exempt Organizations* § 22.6(b)); *Alpine Fellowship Church of Love & Enlightenment v. United States*, 87-1 U.S.T.C. ¶ 9203 (N.D. Cal. 1987).

remedy at law, and advancement of the public interest).[311] Generally, loss of exempt status will not bring an organization within the ambit of this exception, under Supreme Court rulings[312] and other cases.[313] An exception may be available in this context but success will require rather unusual factual circumstances.[314]

An organization facing loss of tax-exempt status or similar adverse treatment from the IRS may petition the U.S. Tax Court for relief following the issuance of notice of tax deficiency (if one can be found)[315] or may pay the tax and sue for a refund in federal district court or the U.S. Court of Federal Claims following expiration of the statutory six-month waiting period.[316] The organization, however, may well become defunct before any relief can be obtained in this fashion, particularly where the ability to attract charitable contributions is a factor, since denial of exempt status also means (where applicable) loss of advance assurance by the IRS of deductibility of contributions. The U.S. Supreme Court recognized the seriousness of this dilemma but concluded that ''although the congressional restriction to post-enforcement review may place an organization claiming tax-exempt status in a precarious financial position, the problems presented do not rise to the level of constitutional infirmities, in light of the powerful governmental interests in protecting the administration of the tax system from premature judicial interference . . . and of the opportunities for review that are available.''[317]

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[311] *Enochs v. Williams Packing & Navigation Co.*, 370 U.S. 1 (1962). For example, *Investment Annuity v. Blumenthal*, 437 F. Supp. 1095 (D.D.C. 1977), 442 F. Supp. 681 (D.D.C. 1977), *rev'd*, 609 F.2d 1 (D.C. Cir. 1979); *State of Minn., Spannaus v. United States*, 525 F.2d 231 (8th Cir. 1975).

[312] *Bob Jones Univ. v. Simon*, 416 U.S. 725 (1974); *''Americans United'' Inc. v. Walters*, 416 U.S. 752 (1974), *rev'g* 477 F.2d 1169 (D.C. Cir. 1973). Also *United States v. American Friends Serv. Comm.*, 419 U.S. 7 (1974); *Cattle Feeders Tax Comm. v. Shultz*, 504 F.2d 462 (10th Cir. 1974); *Vietnam Veterans Against the War, Inc. v. Voskuil*, 389 F. Supp. 412 (E.D. Mo. 1974).

[313] For example, *Crenshaw County Private School Found. v. Connally*, 474 F.2d 1185 (5th Cir. 1973); *Judicial Watch, Inc. v. Rossotti*, 223 F. Supp. 2d 698 (D. Md. 2002); *National Council on the Facts of Overpopulation v. Caplin*, 224 F. Supp. 313 (D.D.C. 1963); *Israelite House of David v. Holden*, 14 F.2d 701 (W.D. Mich. 1926).

[314] *Center on Corporate Responsibility, Inc. v. Shultz*, 368 F. Supp. 863 (D.D.C. 1973). In *The Founding Church of Scientology of Washington, D.C., Inc. v. Director, Federal Bureau of Investigation et al.*, 84-1 U.S.T.C. ¶ 9468 (D.D.C. 1984), the organization was permitted to seek an injunction against the IRS for allegedly engaging in illegal law enforcement and information-gathering activities in violation of the organization's constitutional rights, inasmuch as the lawsuit was not related to tax assessment or collection.

[315] IRC §§ 6212, 6213. For example, *Golden Rule Church Ass'n v. Comm'r*, 41 T.C. 719 (1964). The role and responsibilities of the Chief Counsel of the IRS in tax-exempt organization cases docketed in the U.S. Tax Court is the subject of Rev. Proc. 78-9, 1978-1 C.B. 563.

[316] IRC § 7422; 28 U.S.C. §§ 1346(x)(1), 1491. In the absence of the timely filing of a claim for refund (a jurisdictional prerequisite to this type of court action), this type of suit may not be maintained. Also, *The American Ass'n of Commodity Traders v. Department of the Treasury*, 79-1 U.S.T.C. ¶ 9183 (D.N.H. 1978), *aff'd*, 598 F.2d 1233 (1st Cir. 1979).

[317] *Bob Jones Univ. v. Simon*, 416 U.S. 725, 747–748 (1974).

(b) Declaratory Judgment Rules

Federal tax law provides for declaratory judgments as to the tax status of charitable organizations and farmers' cooperatives.[318] This law authorizes federal court jurisdiction in cases of actual controversy involving determinations (or failures to make a determination) by the IRS with respect to the tax status of charitable organizations. This jurisdiction is vested in the U.S. District Court for the District of Columbia, the U.S. Court of Federal Claims, and the U.S. Tax Court.[319]

This declaratory judgment procedure is designed to facilitate relatively prompt judicial review of five categories of tax-exempt organizations issues.[320] This procedure is not, however, intended to supplant the preexisting avenues available for exempt organizations for judicial review. Jury trials are not available in these types of cases.[321]

(i) General Requirements. These rules create a remedy in a case of actual controversy involving a determination by the IRS with respect to the initial qualification or classification or continuing qualification or classification of an entity as a charitable organization for tax exemption purposes[322] and/or charitable contribution deduction purposes,[323] a private foundation,[324] or a private operating foundation.[325] The remedy is also available in the case of

[318]IRC § 7428. For example, *The Church of the New Testament v. United States*, 783 F.2d 771 (9th Cir. 1986). The reference to charitable organizations is to entities described in IRC § 501(c)(3) (see App. C § I B); the reference to farmers' cooperatives is to organizations described in IRC § 521 (see *Tax-Exempt Organizations* § 19.12).

[319]The U.S. Tax Court is the only one of these courts where this type of a declaratory judgment case can be pursued without the services of a lawyer; these *pro se* cases will be dismissed for that reason in the other two courts (e.g., *Point of Wisdom No. 1 v. United States*, 77 A.F.T.R. 2d 986 (D.D.C. 1996)).

[320]Congress enacted a similar declaratory judgment procedure for ascertaining the tax qualifications of employee retirement plans, as part of the Employee Retirement Income Security Act (IRC § 7476). For example, *Federal Land Bank Ass'n of Asheville, N.C. v. Comm'r*, 67 T.C. 29 (1976), *rev. and rem.*, 573 F.2d 179 (4th Cir. 1978), 74 T.C. 1106 (1980) (*on remand*).

[321]The *Synanon Church v. United States*, 83-1 U.S.T.C. ¶ 9230 (D.D.C. 1983).

[322]That is, an organization described in IRC § 501(c)(3) and exempt from federal income taxation by reason of IRC § 501(a). Reasoning that the question as to whether a trust is a charitable trust within the meaning of IRC § 4947(a)(1) (see App. C § XIII D) is ''inextricably related'' to the issue of whether it is qualified under IRC § 501(c)(3), the Tax Court held that it has declaratory judgment jurisdiction to decide the IRC § 4947(a)(1) issue (*Allen Eiry Trust v. Comm'r*, 77 T.C. 1263 (1981)). In this case, however, the court declined to take jurisdiction over the question as to whether the trust is qualified to have its income exempt from tax under IRC § 115 (see *Tax-Exempt Organizations* § 19.19). The court also declined jurisdiction in an instance where the organization was dissolved prior to the filing of the petition for declaratory relief, on the ground that there was not an actual controversy (*Nat'l Republican Found. v. Comm'r*, 55 T.C.M. 1395 (1988)). Likewise, where an audit by the IRS is undertaken and the organization's tax-exempt status is not altered, there is no actual controversy (*Founding Church of Scientology of Washington, D.C., Inc. v. United States*, 92-1 U.S.T.C. ¶ 50,302 (Cl. Ct. 1992)).

[323]IRC § 170(c)(2).

[324]IRC § 509(a).

[325]IRC § 4942(j)(3).

a failure by the IRS to make a determination as respects one or more of these issues.[326] Furthermore, the remedy is also available with respect to the initial classification or continuing classification of farmers' cooperatives for exemption. The remedy is pursued in one of the three above-noted courts, which is authorized to ''make a declaration'' with respect to the issues.

A determination within the meaning of these rules[327] is a final decision by the IRS affecting the tax qualification of a charitable organization or a farmers' cooperative.[328] The term does not encompass an IRS ruling passing on an organization's proposed transactions, in that this type of ruling does not constitute a denial or revocation of an organization's tax-exempt status nor does it jeopardize the deductibility of contributions to it; thus, absent a final determination, a declaratory judgment is premature.[329] The same principle applies to an IRS ruling concerning an organization's public charity entity classification.[330] In the case of a church, a final report of an IRS agent (the 30-day letter) constitutes the requisite final determination.[331]

A topic of some controversy is whether a tax-exempt organization can litigate, under these declaratory judgment rules, its public charity classification where the IRS accords public charity status to it but in a category different from that requested by the organization. In the first case on the point, the U.S. Tax Court held that it is a justifiable issue[332] for an organization to assert that it is not a private foundation because it is a church rather than a publicly supported organization.[333] The court said that, in this type of an instance, the organization has received the requisite adverse ruling, if only because the organization had requested a definitive ruling yet received only an advance ruling;[334] the IRS unsuccessfully asserted that the declaratory judgment jurisdiction becomes available only where the ruling is ''fully adverse.''[335]

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[326]IRC § 7428(x)(2). Thus, the rulings and determination letters in cases subject to the declaratory judgment procedure of IRC § 7428 are those issued pursuant to the procedures stated in Rev. Proc. 2007-52, 2007-30 I.R.B. 222 (which became effective on July 23, 2007). The withdrawal of an application for recognition of tax exemption is not a failure to make a determination under IRC § 7428(a)(2) (*id*. § 6.02).

[327]IRC § 7428(a)(1).

[328]Rev. Proc. 2007-52, 2007-30 I.R.B. 222 § 12.04.

[329]*New Community Senior Citizen Hous. Corp. v. Comm'r*, 72 T.C. 372 (1979). In one case, the U.S. Tax Court held that the requirement that there be a final adverse determination means that the court lacks jurisdiction to review a determination issued by the IRS only after the organization agreed to not conduct a certain activity in consideration of receipt of the otherwise favorable determination, because the ruling is not ''adverse'' in relation to the proposed activity (*AHW Corp. v. Comm'r*, 79 T.C. 390 (1982)).

[330]*Urantia Found. v. Comm'r*, 77 T.C. 507 (1981), *aff'd*, 684 F.2d 521 (7th Cir. 1982).

[331]IRC § 7611(g).

[332]Under IRC § 7428(a)(1)(B).

[333]See *Tax-Exempt Organizations* § 12.3(b).

[334]See *id*. § 25.3(b).

[335]*Friends of the Soc'y of Servants of God v. Comm'r*, 75 T.C. 209 (1980). Also *Found. of Human Understanding v. Comm'r*, 88 T.C. 1341 (1987).

The U.S. Court of Appeals for the Fifth Circuit, however, endeavored to narrow the reach of this Tax Court decision.[336] While the appellate court agreed that the ''receipt of a favorable ruling on a non-private [foundation] status that is a different and less advantageous status than the one which is the subject of the ruling request will not defeat'' declaratory judgment jurisdiction,[337] the court said it would ''not . . . [interpret] the statute to allow court review of an adverse holding by the Service which has no present effect on a taxpayer's classification'' as a private foundation or nonfoundation.[338] The principal issue before this court of appeals concerned an organization that was ruled to be a donative publicly supported organization; however, the IRS had also ruled, contrary to the position of the organization, that contributions from another organization were subject to the 2 percent limitation on allowable ''public'' contributions.[339] The court rejected the contention that the Tax Court had jurisdiction to entertain the action, concerning proper application of the 2 percent limitation, since the organization was accorded initial classification as a publicly supported charity and since the IRS had not failed to make the requisite determination. Thus, the court concluded that the necessary *actual controversy* was not present and that the organization can litigate the applicability of the 2 percent rule when and if that rule causes the IRS to attempt to adversely classify the organization under the public charity classification rules.[340] Likewise, the U.S. Court of Appeals for the Sixth Circuit held that the courts lack declaratory judgment jurisdiction where an organization is seeking reclassification under the public charity rules.[341]

A pleading may be filed under these rules ''only by the organization the qualification or classification of which is at issue.''[342] Prior to utilizing the declaratory judgment procedure, an organization must have exhausted all

[336]*CREATE, Inc. v. Comm'r*, 634 F.2d 803 (5th Cir. 1981).

[337]*Id*. at 813.

[338]*Id*. at 812.

[339]See *Tax-Exempt Organizations* § 12.3(b)(i).

[340]Inherent in the opinion is the court's concern about overburdening the judicial system with too many IRC § 7428 declaratory judgment cases, for it spoke of a contrary holding giving rise to a ''significant volume of § 7428 litigation, some of which would be needless'' (*CREATE, Inc. v. Comm'r*, 634 F.2d 803, 812 (5th Cir. 1981)).

[341]*Ohio County & Ind. Agric. Soc'y v. Comm'r*, 610 F.2d 448 (6th Cir. 1979), *cert. den*., 446 U.S. 965 (1980)).

[342]IRC § 7428(b)(1). Thus, for example, as regards an unincorporated organization that applied for recognition of tax exemption and subsequently, during the administrative process, incorporated, when the IRS denied exemption for the unincorporated entity, the corporation (being a separate legal entity) was held to lack standing to seek a declaratory judgment on the qualification as an exempt organization of the unincorporated organization (*American New Covenant Church v. Comm'r*, 74 T.C. 293 (1980)). By contrast, a surviving exempt corporation in a merger was held to be able to litigate, under these rules, the issue of exemption of the merged entity; the appellate court looked to state law to determine that the suit could be said to be maintained by ''the organization'' (*Baptist Hosp., Inc. v. United States*, 851 F.2d 1397 (Fed. Cir. 1988), *rev'g* 87-1 U.S.T.C. ¶ 9290 (Ct. Cl. 1987)). A director of an exempt organization lacks standing to bring an action pursuant to these rules (*Fondel v. United States*, 99-1 U.S.T.C. ¶ 50,188 (Fed. Cir. 1999)).

administrative remedies available to it within the IRS.[343] The refusal by an organization to turn records over to the IRS, during the pendency of a contest of the IRS summons, cannot be considered a failure to exhaust administrative remedies that could result in a loss of declaratory judgment rights.[344] For the first 270 days after a request for a determination is made, an organization is deemed to not have exhausted its administrative remedies, assuming a determination has not been made during that period.[345] After this 270-day period has elapsed, the organization may initiate an action for a declaratory judgment. Thus, however, if the IRS makes an adverse determination during this jurisdictional period, an action can be initiated. Nonetheless, all actions under these rules must be initiated within 90 days after the date on which the final determination by the IRS is made.[346] In the case of a church, the receipt of a final report of an IRS agent is deemed to constitute the exhaustion of administrative remedies.[347]

A *determination* can, in this context, include a proposed revocation of an organization's tax-exempt status or public charity classification. In one case, an exempt charitable organization received a letter in which the IRS proposed to revoke its public charity status; in response, it filed a written protest and thereafter filed a petition for a declaratory judgment (under the 270-day rule). After the court petition was filed, the IRS issued a final determination letter revoking the public charity classification of the organization. At issue was whether the court had jurisdiction as the result of the filing of the petition. The IRS contended the court did not, inasmuch as the petition was filed before the final adverse letter was issued. The court disagreed, finding that the proposed revocation was sufficient to create the requisite actual controversy and that the written protest constituted the requisite request for a determination.[348]

In the case, the court concluded that the administrative appeals process had been completed and that the 270-day period had run its course. By contrast, where the administrative process is ongoing and where the IRS has merely threatened to issue notice of proposed revocation, the courts will decline to

[343]In *The Sense of Self Soc'y v. United States*, 79-2 U.S.T.C. ¶ 9673 (D.D.C. 1979), the court ruled that the organization failed to exhaust its administrative remedies because it did not respond to the IRS's ''repeated'' requests for information. Cf. *Change-All Souls Hous. Corp. v. United States*, 671 F.2d 463 (Ct. Cl. 1982).

[344]*Church of World Peace, Inc. v. Internal Revenue Service*, 715 F.2d 492 (10th Cir. 1983).

[345]IRC § 7428(b)(2). Withdrawal of an application for recognition of tax exemption (Form 1023) is not an exhaustion of administrative remedies (Rev. Proc. 2007-52, 2007-30 I.R.B. 222 § 10.02). The filing of an application for recognition of exemption is not a required administrative step for organizations claiming status as a church (see *Tax-Exempt Organizations* § 26.6(b)) (*Universal Life Church, Inc. (Full Circle) v. Comm'r*, 83 T.C. 292 (1984)).

[346]IRC § 7428(b)(3). For example, *Metropolitan Community Serv., Inc. v. Comm'r*, 53 T.C.M. 810 (1987).

[347]IRC § 7611(g).

[348]*J. David Gladstone Found. v. Comm'r*, 77 T.C. 221 (1981).

assume declaratory judgment jurisdiction.[349] Emphasizing the requirement of an *actual controversy*, a court observed that ''[w]e find no grounds for believing that Congress intended this [declaratory judgment] section to grant us plenary authority to supervise examinations of exempt organizations.''[350] This determination was upheld, with the appellate court rejecting the claim of jurisdiction in that the IRS was ''still only in the investigative stage and has not issued any ruling affecting . . . [the organization's] tax exempt status, directly or indirectly.''[351]

In one instance, a court concluded that it had declaratory judgment jurisdiction over a case, where the IRS notified a tax-exempt organization that the agency was considering revocation of its exempt status, even though the complaint in the case was filed before the IRS issued its final adverse determination letter to the organization.[352] Prior to the filing of the court petition, the IRS issued a technical advice memorandum stating that the organization's exemption should be revoked. The government argued that, at the time the petition was filed, there was no actual controversy because the IRS had not yet revoked or officially ''proposed revocation'' of the organization's exempt status. The court, however, held that the organization's ''continuing classification was unquestionably at issue between the parties throughout the entire administrative proceeding.''[353] This court wrote that, after the ''issuance of the technical advice memorandum, final revocation was inevitable'' and thus ''[t]here can be no other conclusion but that an actual controversy existed on the date [the organization] filed its petition herein.''[354]

In this case, there was no ''failure to make a determination'' and there was no ''request for a termination.'' The government did not issue a ''proposed revocation'' and the organization never filed a ''written protest.'' The court examined the administrative status of the case, however, and compared it to the administrative status of an organization that receives a proposed revocation, and concluded that the correspondence from the IRS was ''in substance, procedurally the same'' as a written protest.[355] The court concluded that, by the time the matter was substantively considered by the IRS, a full and complete administrative record had been developed.

In the course of issuance of a favorable determination letter recognizing an organization's tax-exempt status, the IRS not infrequently conditions its ruling on the organization's agreement to not engage in a particular activity. A court held that this type of favorable final ruling does not constitute the requisite

[349] *High Adventure Ministries, Inc. v. Comm'r*, 80 T.C. 292 (1983).
[350] *Id*. at 302.
[351] 726 F.2d 555, 557 (9th Cir. 1984).
[352] *Anclote Psychiatric Center, Inc. v. Comm'r*, 95 T.C. 371 (1992).
[353] *Id*. at 377.
[354] *Id*.
[355] *Id*. at 378.

adverse determination.[356] Indeed, the court starkly wrote that organizations that have exempt status ''have been left with only one means of obtaining judicial review: to engage in the proposed activities despite . . . [the IRS's] adverse ruling, thereby to risk revocation, and to test . . . [the IRS's] position in court in the event of actual revocation.''[357] If an organization concludes that it cannot risk loss of exemption, the court suggested that a new entity be formed to undertake the activities at issue and, if necessary, litigate the matter.[358]

According to the IRS, this 270-day period does not begin until the date a *substantially completed* application for recognition of tax exemption is sent to the agency.[359]

(ii) Exhaustion of Administrative Remedies. As respects the exhaustion of administrative remedies requirement, the IRS is of the view that the following steps and remedies must be exhausted prior to proper initiation of a declaratory judgment action:

1. The filing of a substantially completed application for recognition of tax exemption,[360] or the filing of a request for a determination of public charity/private foundation status
2. The timely submission of all additional information requested to perfect an application for recognition of exemption or request for determination of public charity/private foundation status[361]
3. In appropriate cases, requesting appropriate relief under the rules[362] regarding applications for extensions of the time for making an election or application for relief from tax[363]
4. Exhaustion of all administrative appeals available within the IRS[364]

[356] *AHW Corp. v. Comm'r*, 79 T.C. 390 (1982).
[357] *Id*. at 394–395.
[358] *Id*. at 398, note 5.
[359] Rev. Proc. 2007-52, 2007-30 I.R.B. 222 § 10.02(1).
[360] See *Tax-Exempt Organizations* § 25.1(b).
[361] See *id*., Chapter 12.
[362] Reg. § 1.9100.
[363] Rev. Proc. 79-63, 1979-2 C.B. 578.
[364] Rev. Proc. 2007-52, 2007-30 I.R.B. 222 § 10.02. An organization that was repeatedly dilatory in responding to IRS inquiries, leading the agency to close the file, was found to have not exhausted its administrative remedies for ''failure to proceed with due diligence'' (*Nat'l Paralegal Inst. Coalition v. Comm'r*, 90 T.C.M. 623, 625 (2005)). During the course of exchanges of correspondence, this organization denied receiving a letter from the IRS, yet in a subsequent response to the agency it included an item of information that was the subject of an inquiry in the letter from the IRS that it claimed to have not received; this was information that it could not have known to provide absent the IRS question. The court found that the organization in fact received the letter, applying an *extension of the knowledge principle*, a rule of evidence that allows for proof of receipt of a letter by application of the *reply letter doctrine*, where the ''inherent nature'' of a communication makes it obvious that it is a ''reply communication'' (*id*.).

According to the IRS, an organization cannot be deemed to have exhausted its administrative remedies prior to the earlier of (1) the completion of the foregoing steps and the sending of a notice of final determination by certified or registered mail, or (2) the expiration of the 270-day period in a case where the IRS has not issued a notice of final determination and the organization has taken, in a timely manner, all reasonable steps to secure a ruling or determination.[365]

Further, the IRS stated that the foregoing steps ''will not be considered completed until the Service has had a reasonable time to act upon an appeal or protest[,] as the case may be.''[366] (As noted, nonetheless, once the statutory 270 days have elapsed, the action can be initiated, without regard to the pace of the IRS in relation to these steps.)

(iii) Deductibility of Contributions. To protect the financial status of an allegedly charitable organization during the litigation period, the law provides for circumstances under which contributions made to the organization during that period are deductible[367] even though the court ultimately decides against the organization.[368] Basically, this relief can be accorded only where the IRS is proposing to revoke, rather than initially deny, an organization's charitable status. The total deductions to any one organization from a single donor, to be so protected during this period, however, may not exceed $1,000.[369] (Where an organization ultimately prevails in a declaratory judgment case, this $1,000 limitation on deductibility becomes inapplicable, so that all gifts are fully deductible within the general limitations of the charitable deduction rules.[370]) This benefit is not available to any individual who was responsible, in whole or in part, for the actions (or failures to act) on the part of the organization that were the basis for the revocation of tax-exempt status.[371]

When the IRS revokes an organization's tax exemption, that action is usually the result of an audit of the organization's activities for one or more

[365]Rev. Proc. 2007-52, 2007-30 I.R.B. 222 § 10.03.

[366]*Id*. § 10.04. The U.S. District Court for the District of Columbia held that it lacks subject-matter jurisdiction in these cases until the IRS makes an adverse determination or the 270-day period (commenced by the filing of a substantially completed application for recognition of exemption) has elapsed (*New York County Health Servs. Review Org., Inc. v. Comm'r*, 80-1 U.S.T.C. ¶ 9398 (D.D.C. 1980)).

[367]IRC § 170(c)(2).

[368]IRC § 7428(c)(1).

[369]IRC § 7428(c)(2)(A).

[370]See, e.g., *Charitable Giving*, Chapter 7.

[371]IRC § 7428(c)(3). The IRS publishes, in the Internal Revenue Bulletin, the names of organizations that are challenging, under IRC § 7428, the revocation of their status as organizations entitled to receive deductible charitable contributions, so as to inform potential donors to these organizations of the protection, to the extent provided under IRC § 7428(c), for their contributions made during the litigation period (Ann. 85-169, 1985-48 I.R.B. 40). In general, Kittrell, ''Administrative Prerequisites for Declaratory Judgments about Tax Issues,'' 66 *A.B.A.J*. 1570 (1980); Roady, ''Declaratory Judgments for 501(c)(3) Status Determinations: End of a 'Harsh Regime,''' 30 *Tax Law*. 765 (1977).

years. When a revocation of exemption occurs, the IRS inevitably makes a public announcement that the organization is no longer exempt and that contributions to it are no longer deductible. Thus, for example, once such a revocation occurs, and the organization does not take any affirmative steps to restore its exemption, a gift to the organization would not be tax-deductible, even when made in a year subsequent to one of the audit years. A court in a declaratory judgment case only has jurisdiction in relation to the audit years, inasmuch as the requisite determination with respect to those years has been made. As to the subsequent years, court jurisdiction does not exist because there is no determination with respect to those years. The remedy available to an organization in these circumstances is to file an application for recognition of exemption for the subsequent period. The manner in which the IRS responds to the filing will determine whether the organization needs to proceed in court for those years—in any event, that response will be the determination needed to vest a court with declaratory judgment jurisdiction.[372]

(iv) Administrative Record. The U.S. Tax Court is the only one of the three courts to adopt procedural rules for actions filed under these rules.[373] The single most significant feature of these rules is the decision of the court to generally confine its role to review of the denial by the IRS of a request for a determination of tax exemption based solely on the facts contained in the administrative record, that is, not to conduct a trial *de novo* at which new evidence maybe adduced.[374] (This approach does not apply where the exemption has been revoked.)

Thus, in one case, the court refused to permit information orally furnished to IRS representatives during a conference at the administrative level to be introduced in evidence during the pendency of the case before it.[375] Likewise, it was held that the administrative record may consist only of material submitted

[372]*The Synanon Church v. United States*, 83-1 U.S.T.C. ¶ 9230 (D.D.C. 1983).

[373]Rules of Practice and Procedure, U.S. Tax Court, Title XXI.

[374]*Id*., Rule 217(a). For example, *The Nationalist Movement v. Comm'r*, 64 T.C.M. 1479 (1992); *Dr. Erol Bastug, Inc. v. Comm'r*, 57 T.C.M. 562 (1989); *Colorado State Chiropractic Soc'y, Inc. v. Comm'r*, 56 T.C.M. 1018 (1989); *Liberty Ministries Int'l v. Comm'r*, 48 T.C.M. 105 (1984); *Unitary Mission Church of Long Island v. Comm'r*, 74 T.C. 507 (1980). The U.S. Tax Court is concerned about ''fishing expeditions'' in these situations (e.g., *Wisconsin Psychiatric Servs. v. Comm'r*, 76 T.C. 839, 846 (1981)). This court has allowed supplementation of the administrative record in a denial-of-exemption case (*First Libertarian Church v. Comm'r*, 74 T.C. 396 (1980)). The U.S. District Court for the District of Columbia, however, appears more willing to review facts beyond the administrative record (e.g., *Freedom Church of Revelation v. United States*, 588 F. Supp. 693 (D.D.C. 1984); *Incorporated Trustees of the Gospel Worker Soc'y v. United States*, 510 F. Supp. 374 (D.D.C. 1981); *aff'd*, 672 F.2d 894 (D.C. Cir. 1981), *cert. den*., 456 U.S. 944 (1982) (cf. *Airlie Found., Inc. v. United States*, 92-2 U.S.T.C. ¶ 50,462 (D.D.C. 1992)). Because the Tax Court will render a declaratory judgment in a nonrevocation case on the petition, the answer, and the administrative record, it has held that a motion for summary judgment in that court is ''superfluous'' and ''pointless'' (*Pulpit Resource v. Comm'r*, 70 T.C. 594, 602 (1978)).

[375]*Houston Lawyer Referral Serv., Inc. v. Comm'r*, 69 T.C. 570 (1978). Also *Church in Boston v. Comm'r*, 71 T.C. 102 (1979).

by either the applicant organization or the IRS, so that materials submitted by third parties are inadmissible.[376] Similarly, the court is to base its decision only upon theories advanced in the IRS notice or at trial, and not on arguments advanced anew by the IRS during the litigation.[377]

The U.S. Tax Court suggested that, if an organization that has been denied tax exemption and did not prevail before it has material information previously excluded from the administrative record, the organization may file a new application for recognition of exemption and that the principles of *res judicata* would not preclude the court from reviewing a denial of the subsequent application.[378]

The general Tax Court scheme for the processing of these declaratory judgment cases is being adopted, on a case-by-case basis, by both the U.S. District Court for the District of Columbia and the U.S. Court of Federal Claims. This approach includes basic reliance on the administrative record, with court review *de novo* only in unusual cases.[379]

An organization's fate before a court may well depend on the quality of the contents of the administrative record. The applicant organization, significantly, generally controls what comprises the administrative record. Even when the record includes responses to IRS inquiries, it is the organization that decides the phraseology of the answers and what, if anything, to attach as exhibits. It is, therefore, important that the administrative record be carefully constructed, particularly in instances where there is a reasonable likelihood that an initial determination case will be unsuccessful at the IRS level and thus ripen into a declaratory judgment case.

As an illustration, a court had before it the issue as to whether an organization that operated a mountain lodge as a retreat facility could qualify

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[376] *Church of Spiritual Technology v. United States*, 90-1 U.S.T.C. ¶ 50,097 (Ct. Cl. 1989). A court ruled that transcripts from the criminal trials and the grand jury materials from the criminal case, involving the founder and executive director of an organization, were part of the administrative record in a subsequent case where the organization's ongoing tax-exempt status was at issue (*Airlie Found., Inc. v. United States*, 92-2 U.S.T.C. ¶ 50,462 (D.D.C. 1992).

[377] *Peoples Translation Service/Newsfront Int'l v. Comm'r*, 72 T.C. 42 (1979); *Goodspeed Scholarship Fund v. Comm'r*, 70 T.C. 515 (1978); *Schuster's Express, Inc. v. Comm'r*, 66 T.C. 585 (1976), *aff'd*, 562 F.2d 39 (2d Cir. 1977).

[378] *Houston Lawyer Referral Serv., Inc. v. Comm'r*, 69 T.C. 570, 577–578 (1978).

[379] For example, *Southwest Va. Professional Standards Review Org., Inc. v. United States*, 78-2 U.S.T.C. ¶ 9747 (D.D.C. 1978); *Animal Protection Inst., Inc. v. United States*, 78-2 U.S.T.C. ¶ 9709 (Ct. Cl. 1978).

In *Synanon Church v. United States*, 579 F. Supp. 967 (D.D.C. 1984), *aff'd*, 87-1 U.S.T.C. ¶ 9347 (D.C. Cir. 1987), the court dismissed the case on the ground of fraud upon the court, based on the court's finding that the organization destroyed material records.

The U.S. Tax Court will not consolidate a declaratory judgment case with a regular tax deficiency case, even where the issues are the same and a trial may be available in both instances (*Centre for Int'l Understanding v. Comm'r*, 84 T.C. 279 (1985)).

The Tax Court ruled that an IRC § 7428 declaratory judgment petition may be dismissed for failure of the organization to prosecute the case (*Basic Bible Church of America v. Comm'r*, 86 T.C. 110 (1986)).

as a tax-exempt religious organization. The opinion in the case reflected the court's view that this type of organization can so qualify under appropriate circumstances, yet the organization involved lost the case primarily because the administrative record did not show that the recreational facilities were used for exempt purposes or otherwise used only in an insubstantial manner.[380] By contrast, where the administrative record is able to show that an organization is advancing exempt purposes by means of a religious retreat, the courts will not deprive the organization of exemption, even where the retreats are held in an environment somewhat more attractive than the wilderness.[381]

The impact of this declaratory judgment procedure on the administrative practice before the IRS cannot be underestimated. In the past, the IRS could be confident that, with rare exception, its determination as to a charitable organization's tax status was the final one. That is, because of the large amount of legal fees, other expenses, and time required to litigate, the agency knew that judicial review of one of its decisions in this area would be highly unlikely.

With the advent of the declaratory judgment rules, all this has dramatically changed. No longer can the IRS make its decisions with the luxury of assuming their finality. Now, the agency, in approaching this decision-making process, must do so with awareness of the greatly increased possibility of a challenge in court. This means that the IRS, obviously reluctant to have a rebuff in the case-books as precedent, may well be forced to issue favorable rulings in instances where the contrary would otherwise be the case. Also, these procedures can force the agency to act more quickly than it may otherwise be disposed to do.

In one instance, the IRS refused to rule on a request for recognition of exemption, saying that the issue raised was under study. Once the 270-day administrative remedies period expired, the organization launched a lawsuit. Within 60 days after the complaint was filed, the Department of Justice made it known that the IRS was willing to issue a favorable ruling (thereby mooting the case). Thus, soon after instituting a declaratory judgment request, the organization came into possession of a favorable ruling, under circumstances where, if this form of relief were not available, the IRS probably would not have acted for some time or would have issued an unfavorable determination.[382]

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[380] *The Schoger Found. v. Comm'r*, 76 T.C. 380 (1981). The organization argued that the administrative record did not show that the recreational facilities were used in an insubstantial manner but this failed because, under the U.S. Tax Court Rules of Practice and Procedure (Rule 217(c)(2)(i)), the organization had the burden of showing that the determination of the IRS is incorrect. Cf. *Alive Fellowship of Harmonious Living v. Comm'r*, 47 T.C.M. 1134 (1984).

[381] *Junaluska Assembly Hous., Inc. v. Comm'r*, 86 T.C. 1114 (1986).

[382] *Infant Formula Action Coalition v. United States* (C.A. No. 79-0129, D.D.C.); also *Fair Campaign Practices Comm., Inc. v. United States* (C.A. No. 77-0830, D.D.C.). One veteran lawyer advised on these points as follows: ''Declaratory judgment actions involving denials of exemption are heard on the basis of the administrative record. Therefore, it is imperative for the taxpayer [exempt organization] representatives to ensure that the administrative record is complete. This obviously creates an opportunity to create a compelling case why exemption should be granted in the first place, and not denied.'' (''Handling Controversies with the IRS,'' at 2.)

(v) Development of Law. These procedures are not solely of consequence to organizations that are attempting to obtain tax exemption and/or private foundation/public charity status. They are also of immense significance to the established charitable (including educational, religious, and scientific) organization or institution, the tax status of which is, or appears to be, immune from revocation or other disturbance. This declaratory judgment provision is having a considerable impact on development of the law applicable to charitable organizations.

The courts are holding a variety of organizations to be tax-exempt entities, in rejection of IRS positions. As illustrations, the courts have concluded, notwithstanding the opposition of the IRS, that health maintenance organizations,[383] professional standards review organization foundations,[384] consumer credit counseling agencies,[385] and private schools providing custodial services for young pupils[386] can qualify for exemption. The courts, however, are also upholding the IRS position, such as in the case of genealogical societies,[387] communal groups,[388] and certain scholarship funds.[389] Interpretations of the private foundation definition rules have gone for and against the government.[390]

Consequently, the growing use of these procedures creates a significant impact on the law encompassing the reach of the tax exemption for charitable organizations. This can be of considerable importance in the continuing preservation of organizations' exempt and/or private foundation classifications.

Moreover, the breadth of the issues being raised by these cases is fostering the rapid development of law in areas related to tax exemption other than as regards the exemption categories themselves. Chief among these areas being explored and expounded on is the doctrine of *private inurement*.[391] Many of these cases under review and being decided are turning on the question of whether private interests are being unduly served. Thus, two courts have found that genealogical societies improperly (for tax-exemption purposes)

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[383] *Sound Health Ass'n v. Comm'r*, 71 T.C. 158 (1978).

[384] *Virginia Professional Standards Review Found. v. Blumenthal*, 466 F. Supp. 1164 (D.D.C. 1979).

[385] *Consumer Credit Counseling Serv. of Ala., Inc. v. United States*, 78-2 U.S.T.C. ¶ 9660 (D.D.C. 1978). In a rare development, the rules in this area have been largely supplanted by statutory law (IRC § 501(q) (see *Tax-Exempt Organizations* § 7.3(e)).

[386] *San Francisco Infant School, Inc. v. Comm'r*, 69 T.C. 957 (1978); *Michigan Early Childhood Center, Inc. v. Comm'r*, 37 T.C.M. 808 (1978).

[387] *The Callaway Family Ass'n, Inc. v. Comm'r*, 71 T.C. 340 (1978); *Benjamin Price Genealogical Ass'n v. Internal Revenue Service*, 79-1 U.S.T.C. ¶ 9361 (D.D.C. 1979). Also *Manning Ass'n v. Comm'r*, 93 T.C. 596 (1989) (holding that an association of descendants of a settler from England in the United States in the 1600s did not qualify for tax exemption as an educational organization, in part because of the compilation of genealogical information).

[388] *Beth-El Ministries, Inc. v. United States*, 79-2 U.S.T.C. ¶ 9412 (D.D.C. 1979).

[389] *Miss Georgia Scholarship Fund, Inc. v. Comm'r*, 72 T.C. 267 (1979). Cf. *Wilson v. United States*, 322 F. Supp. 830 (D. Kan. 1971).

[390] For example, *William F., Mabel E. & Margaret K. Quarrie Charitable Fund v. Comm'r*, 70 T.C. 182 (1978), *aff'd*, 603 F.2d 1274 (7th Cir. 1979).

[391] See *Tax-Exempt Organizations*, Chapter 20.

provide personal services to members when the societies help their members research their ancestry.[392] One set of cases has resulted in opinions that there is unwarranted private inurement with respect to a religious organization because of its communal structure, where meals, lodging, and other life necessities are provided to the ministers.[393] Other decisions contain analyses as to why particular facts may concern educational efforts,[394] or may involve private inurement, or why the inurement that is present is either insubstantial or unavoidable and incidental.[395]

These cases are also triggering examinations of the requirement that tax-exempt organizations be organized and operated exclusively for exempt purposes. The parameters of this requirement are being tested by cases that involve questions such as whether, or the extent to which, a charitable organization can operate at a profit or can provide services to members.[396]

The courts in these declaratory judgment cases are also paying close attention to the technical essentials of the organizational test.[397] In one case, a court ruled that an organization could not qualify for tax exemption because of a defect in its articles of organization, in that the articles did not expressly preclude the possibility of a violation of the test by operation of state law.[398]

Current and future developments in this area will continue to have an enormous impact on the revision and expansion of the federal tax law applicable to charitable (and, to some degree, other tax-exempt) organizations. These procedures are contributing to the federal tax law affecting charitable organizations on many fronts.

(c) Other Approaches

Other options may be available, as to court jurisdiction, for the organization confronted with revocation (or denial) of tax-exempt status. Where charitable

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[392]See *supra* note 387.

[393]See *supra* note 388.

[394]*Big Mama Rag, Inc. v. United States*, 631 F.2d 1030 (D.C. Cir. 1980), *rev'g and rem'g*, 494 F. Supp. 473 (D.D.C. 1979); *Afro-American Purchasing Center, Inc. v. Comm'r*, 37 T.C.M. 184 (1978).

[395]*Christian Stewardship Assistance, Inc. v. Comm'r*, 70 T.C. 1037 (1978), *aff'd*, 647 F.2d 170 (9th Cir. 1981); *est of Hawaii v. Comm'r*, 71 T.C. 1067 (1979); *Federation Pharmacy Servs., Inc. v. Comm'r*, 72 T.C. 687 (1979), *aff'd*, 625 F.2d 804 (8th Cir. 1980).

[396]*Pulpit Resource v. Comm'r*, 70 T.C. 594 (1978); *National Ass'n for the Legal Support of Alternative Schools v. Comm'r*, 71 T.C. 118 (1978); *Aid to Artisans, Inc. v. Comm'r*, 71 T.C. 202 (1978); *Christian Manner Int'l, Inc. v. Comm'r*, 71 T.C. 661 (1979); *Peoples Translation Service/Newsfront Int'l v. Comm'r*, 72 T.C. 42 (1979); *Industrial Aid for the Blind v. Comm'r*, 73 T.C. 96 (1979); *The Schoger Found. v. Comm'r*, 76 T.C. 380 (1981).

[397]See App. C § II A.

[398]*General Conference of the Free Church of America v. Comm'r*, 71 T.C. 920 (1979). In general, Lehrfeld, ''Section 501(c)(3) Appeals—Declaratory Judgments for Establishing Exemption,'' 43 *N.Y.U. Inst. on Fed. Tax*. 18 (1985); Winslow & Ash, ''Forum Shopping Has Distinct Advantages in Seeking Declaratory Judgments on Exemption,'' 51 *J. Tax*. 112 (1979); McGovern, ''The New Declaratory Judgment Provision for 501(c)(3) Organizations: How It Works,'' 47 *J. Tax*. 222 (1977).

contributions are involved, a ''friendly donor'' may bring an action contesting the legality of the IRS disallowance of the charitable deduction, which generally will involve the same issues as those relating to exemption.[399] A lawsuit of this nature, however, requires a plaintiff who is willing to be subjected to a tax audit, and the organization may lose control over the management of the litigation. An organization may also sue for refund of Federal Unemployment Tax Act (FUTA) taxes,[400] excise taxes,[401] or wagering taxes.[402] While these avenues of review can take much more time than a declaratory judgment action, they offer the distinct advantage of enabling the organization to initiate the litigation in a federal court geographically proximate to it.

Conventional declaratory judgment suits[403] are of no avail in this setting, as the Declaratory Judgment Act expressly excludes controversies over federal taxes from its purview.[404]

One of the considerations in determining the nature of litigation in the tax-exempt organizations context is the likelihood of the award of reasonable litigation costs. This type of award can be made in the case of a civil proceeding brought by or against the federal government in connection with the determination, collection, or refund of any federal tax.[405] This award is accorded to the prevailing party that establishes that the position of the government in the proceeding ''was not substantially justified'' and has substantially prevailed with respect to the amount in controversy or the ''most significant issue or set of issues presented.''[406] An award is not available with respect to any declaratory judgment proceeding, however, other than a proceeding that involves the revocation of a determination that the organization is a charitable entity.[407]

Once an organization has secured a final determination from a court that it is tax-exempt, and if the material facts and law have not changed since court consideration, the IRS will, on request, issue a ruling or determination letter recognizing the exemption. If, however, the organization did not previously

[399]For example, *Teich v. Comm'r*, 48 T.C. 963 (1967), *aff'd*, 407 F.2d 815 (7th Cir. 1969); *Krohn v. United States*, 246 F. Supp. 341 (D. Col. 1965); *Kuper v. Comm'r*, 332 F.2d 562 (3rd Cir. 1964), *cert. den*., 379 U.S. 902 (1964); *Bolton v. Comm'r*, 1 T.C. 717 (1943).
[400]IRC § 3306(c)(8).
[401]IRC § 4253(h).
[402]IRC § 4421. Also *Rochester Liederkranz, Inc. v. United States*, 456 F.2d 152 (2d Cir. 1972); *Hessman v. Campbell*, 134 F. Supp. 415 (S.D. Ind. 1955).
[403]28 U.S.C. §§ 2201–2202.
[404]For example, *Ecclesiastical Order of the ISM of AM, Inc. v. Internal Revenue Service*, 725 F.2d 398 (6th Cir. 1984); *Mitchell v. Riddell*, 401 F.2d 842 (9th Cir. 1968), *cert. den*., 394 U.S. 456 (1969); *In re Wingreen Co*., 412 F. 2d 1048 (5th Cir. 1969); *Jolles Found., Inc. v. Moysey*, 250 F.2d 1966 (2d Cir. 1957); *The Church of the New Testament, Its Members & Friends v. United States*, 85-1 U.S.T.C. ¶ 9227 (E.D. Col. 1984); *Int'l Tel. & Tel. Corp. v. Alexander*, 396 F. Supp. 1150 (D. Del. 1975); *Kyron Found. v. Dunlop*, 110 F. Supp. 428 (D.D.C. 1952).
[405]IRC § 7430(a).
[406]IRC § 7430(c)(2).
[407]IRC § 7430(b)(3).

file an application for recognition of exempt status, the IRS will not issue the ruling or determination letter until the application is submitted.[408]

Absent relief administratively or in the courts, an organization facing loss of tax-exempt status has no choice but to accept the revocation, discontinue the disqualifying activity (if its activities are sufficiently separable), and reestablish its exemption,[409] or spin the disqualifying activity off into a taxable subsidiary[410] or an auxiliary exempt organization[411] and reestablish its exemption. Or, the organization may attempt an alternative to formal exempt status, such as by operating as a nonexempt cooperative.[412]

[408]Rev. Proc. 80-28, 1980-1 C.B. 680.

[409]*Compare Danz v. Comm'r*, 18 T.C. 454 (1952), *aff'd*, 231 F.2d 673 (9th Cir. 1955), *cert. den.*, 352 U.S. 828 (1956), *reh. den.*, 353 U.S. 951 (1957), with *John Danz Charitable Trust v. Comm'r*, 32 T.C. 469 (1959), *aff'd*, 284 F.2d 726 (9th Cir. 1960).

[410]*American Inst. for Economic Research, Inc. v. United States*, 302 F.2d 934 (Ct. Cl. 1962), *cert. den.*, 372 U.S. 976 (1963); Rev. Rul. 54-243, 1954-1 C.B. 92. See *Tax-Exempt Organizations* Chapter 29.

[411]*Center on Corporate Responsibility, Inc. v. Shultz*, 368 F. Supp. 863 (D.D.C. 1973). See *Tax-Exempt Organizations*, Chapter 28.

[412]See *Tax-Exempt Organizations* § 3.5. In general, Friedland, ''Constitutional Issues in Revoking Religious Tax Exemptions: *Church of Scientology of California v. Commissioner*,'' 39 *U. Fla. L. Rev.* 565 (1985); Yaffa, ''The Revocation of Tax Exemptions and Tax Deductions for Donations to 501(c)(3) Organizations on Statutory and Constitutional Grounds,'' 30 *U.C.L.A. L. Rev.* 156 (1982). The proposed revocation of the tax-exempt status of the public charity known as the Bishop Estate, in Hawaii, and the IRS's insistence on resignation or removal of its trustees as a condition of settlement (which occurred) stimulated discussion as to the propriety of the IRS's stance in the case. For example, Brody, ''A Taxing Time for the Bishop Estate: What Is the IRS's Role in Charity Governance?,'' 21 *Univ. Hawaii L. Rev.* (no. 2), 537 (Winter 1999).

CHAPTER FOUR

IRS Compliance Check Projects

Recent years have brought many changes to the tax-exempt organizations component of the IRS—the Exempt Organizations Division—principally under the leadership of then-Commissioner of Internal Revenue Charles Rossotti (emphasis on administration and the provision of services), then-Commissioner Mark W. Everson (emphasis on enforcement), and (as to policy direction) Commissioner, Tax Exempt and Government Entities, Steven T. Miller, and Division Director Lois Lerner. The agency, among other emphases, is trying to extract more policy results, and taxes and penalties, using its limited resources. One of the manifestations of this effort is the compliance check project program. The IRS's Exempt Organizations Compliance Unit (EOCU) generally orchestrates the conduct of these programs.[1]

[1]See § 2.3(d).

§ 4.1 COMPLIANCE CHECK PROJECTS PROGRAM

As noted, the IRS's compliance check projects entail forms of examinations of tax-exempt organizations that are driven by specific compliance issues, as contrasted with audits of exempt organizations analyzing the entities' overall compliance with the law of tax-exempt organizations.[2] A definition of an IRS *compliance project* is a project that is ''designed to address an identified issue, which may or may not be associated with a particular market segment.''[3] This summary of these projects added: ''In the past, the EO function has conducted compliance projects to assess and address known areas of noncompliance through examinations, compliance checks, and educational programs. These projects are managed by a project team, which is responsible for developing a strategy to address the issue if a method to address the issue is not readily apparent.''[4] A *compliance check* is a ''review conducted by the IRS to determine whether an organization is adhering to recordkeeping and information reporting requirements and whether an organization's activities are consistent with their [*sic*] stated tax-exempt purpose.''[5] These compliance check projects are traceable to the massive effort by the IRS to examine, and largely revoke the tax exemption of, all of the nation's nonprofit credit counseling organizations.[6] (An in-tandem program was and is denial of recognition of exemption to nearly all applicant credit counseling entities.)

Beginning in 2002, after nearly 25 years of quietude on the subject, the IRS renewed its efforts to revoke or deny recognition of tax exemption of nonprofit credit counseling agencies.[7] The agency, in 2003, in conjunction with the Federal Trade Commission and state regulators, launched, with then-Commissioner Everson in the forefront, a program of intense review of

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[2]See § 1.6(d).

[3]Treasury Inspector General for Tax Administration, ''Tax-Exempt Hospital Industry Compliance with Community Benefit and Compensation Practices Is Being Studied, but Further Analyses Are Needed to Address Any Noncompliance'' 5, note 10 (no. 2007-10-061) (Mar. 29, 2007).

[4]*Id*.

[5]*Id*. at 6, note 11.

[6]See *Tax-Exempt Organizations* § 7.3. As this particular compliance check program was winding down, Congress in 2006 enacted criteria for exemption for credit counseling entities (IRC § 501(q) (*Tax-Exempt Organizations* § 7.3(e)).

[7]This intense effort was stimulated and augmented by considerable interest in this matter by Congress, which is atypical of IRS compliance check projects. Also, then-Commissioner Everson became directly involved in this enforcement undertaking; in testimony in 2005 before a congressional committee, he spoke of credit counseling organizations that have ''moved from their original purposes, that is, to counsel and educate troubled debtors, to inappropriately enrolling debtors in proprietary debt-management plans and credit-repair schemes for a fee'' and organizations that are ''rewarding their insiders by negotiating service contracts with for-profit entities owned by related parties'' (Senate Committee on Finance, Hearing on Exempt Organizations: Enforcement Problems, Accomplishments, and Future Direction, testimony of Commissioner Mark W. Everson, April 5, 2005).

these organizations.[8] The IRS made examination of these organizations one of its top enforcement priorities at the time. A similar exercise has been unfolding in connection with down payment assistance organizations.[9]

Another area of the law of tax-exempt organizations that the IRS generally disregarded over the decades was the rule that exempt charitable organizations may not—if they wish to remain exempt—participate or intervene in political campaigns on behalf of or in opposition to one or more candidates for public office; then-Commissioner Everson, in 2004, abruptly changed the IRS's course in this regard and plunged the agency into a substantial enforcement (and educational) effort on the subject.[10] He also was instrumental in causing the IRS to focus on the compensation of exempt organizations' executives.[11] Other past and present IRS initiatives in this regard are the agency's hospital compliance project,[12] intermediate sanctions reporting project,[13] the fundraising costs reporting project,[14] and the tax-exempt bonds recordkeeping compliance project.[15] Unlike conventional audits, the IRS usually publicly disseminates information resulting from a compliance check project, thus coupling enforcement with education (and law-making).[16]

§ 4.2 CONCEPT OF MARKET SEGMENT STUDY

There can be conceptual overlap between a compliance project and a market segment study. As noted, a compliance project is a project that ''may or may not be associated with a particular market segment.''[17] The concept of the market segment study emerged in the aftermath of the IRS reorganization,[18] when, around 2001, the agency became engaged in what was proposed to be a wholesale analysis of the tax-exempt sector. In this connection, the IRS began viewing what it called the *exempt organizations community* as a cluster of *market segments*. Thus, the IRS Exempt Organizations Implementing Guidelines for

[8]IR-2003-120; FS-2003-17.

[9]See *Tax-Exempt Organizations* § 7.5. Then-Commissioner Everson was tough on these entities as well. The IRS stated that organizations that ''provide seller-funded down-payment assistance to home buyers do not qualify as tax-exempt charities'' (IR-2006-74); this press release is titled ''IRS Targets Down-Payment-Assistance Scams.''

[10]See § 4.4.

[11]See § 4.3.

[12]See § 4.5.

[13]See § 4.6.

[14]See § 4.7.

[15]See § 4.8.

[16]For example, in conjunction with its examination of down payment assistance organizations, the IRS published criteria for tax exemption for these entities (Rev. Rul. 2006-27, 2006-1 C.B. 915); following its inquiries into charitable organizations' involvement in political campaigns, the IRS issued guidance as to what is and is not political campaign involvement (Rev. Rul. 2007-41, 2007-25 I.R.B. 1421).

[17]See text accompanied by *supra* note 3.

[18]See § 2.2, text accompanied by notes 16, 17, 24–29.

fiscal year 2002 stated that the ''EO community is comprised of widely diverse segments of organizations and widely diverse needs.''[19]

A newly formed EO Compliance Council began identifying market segments within the tax-exempt organizations community, and collated information (including compliance data) for each segment and analyzed the ''compliance risks'' associated with each of the segments. (The number of these segments was always fluid, ranging from 35 to 42.) The plan was to research each segment, using statistically valid sampling techniques (including review of about 150 annual information returns for each segment); the profiles were to measure compliance with all federal tax law requirements applicable to the discrete segment. The results of the completed samples and profiling activities were to be used in formulating the IRS's EO Compliance Program Plan.

This ambitious market segment study program was launched with the government's fiscal year 2002, with six studies.[20] Five more studies were added in connection with the fiscal year 2003 plan,[21] plus two nonstatistical studies.[22] The IRS efforts with respect to fiscal year 2004 brought three more studies.[23] Then, this massive project began to collapse, largely because the resources of the EO Division were being diverted in other, more pressing, directions; in the EO Implementing Guidelines for fiscal year 2005, the IRS announced that no new market segment studies would be initiated due to its focus on other ''critical compliance initiatives.'' The EO Implementing Guidelines for fiscal years 2006 and 2007 were essentially silent on new studies.

The IRS had announced that three of the first market segment study reports would be published in the first quarter of calendar year 2004. The agency also said that five other reports would be concluded and made available by the fourth quarter of fiscal year 2004. Not one of these reports has materialized. Along the way (in early 2005), the Treasury Inspector General for Tax Administration[24] audited the IRS's market segment research program, and made recommendations to resuscitate and advance this initiative. According to the resultant TIGTA report, the EO Division was ''evaluating how to develop a more sophisticated workload selection system that will provide better data to identify productive cases for compliance efforts.''[25] The TIGTA effort was of no avail; the formal market segment study program imploded, then disappeared.

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[19]The various IRS EO Implementing Guidelines are summarized in *Fundraising* § 6.3A (2007 Cum. Supp.).

[20]The segments initially selected were community foundations, social service organizations, religious organizations (other than churches), labor organizations, business leagues, and social clubs (see App. C § V C, I C, I K, I M, I N).

[21]These segments were elder housing organizations, arts and humanities organizations, private foundations, supporting organizations, and fraternal organizations (see App. C § V A, V D, I O).

[22]These segments were colleges and universities, and hospitals.

[23]These segments were fundraising organizations, private schools, and nonexempt trusts.

[24]See § 2.1(b).

[25]TIGTA report 2005-10-020.

But this program did not vanish without any trace. The spirit of it lives on. Many of the compliance check projects have manifestations of a market segment analysis, such as those involving hospitals, credit counseling organizations, and down payment assistance providers. Indeed, in the fiscal year 2007 EO Implementing Guidelines, the IRS announced two new projects: examination of income and expense allocations by colleges and universities in the realm of unrelated business, and review of law compliance by community foundations.

§ 4.3 EXECUTIVE COMPENSATION COMPLIANCE INITIATIVE

The IRS announced an Executive Compensation Compliance Initiative in mid-2004.[26] This effort was formally launched on August 10, 2004, when the agency stated that it was going to ''identify and halt'' the practice of some tax-exempt organizations of paying excessive compensation and other benefits to insiders. The purposes of this project were to:

- Address the compensation of specific individuals or instances of questionable compensation practices.
- Increase awareness of the tax law issues involved as organizations establish amounts and types of compensation in the future.
- Enable the IRS to learn more about the practices that exempt organizations are following as they set compensation and report it on their annual information returns.

The IRS, on March 1, 2007, published a report on its findings as a consequence of this executive compensation initiative.[27]

(a) Law Backdrop

Two significant bodies of law, from a federal tax law standpoint, inform the matter of executive compensation paid by tax-exempt organizations. The doctrine of *private inurement* is one of the most important sets of rules constituting the law of exempt organizations; indeed, it is the fundamental defining principle of law that distinguishes *nonprofit organizations* from *for-profit organizations*.[28] The private inurement doctrine is a statutory criterion for federal income tax exemption for 13 categories of exempt organizations, including charitable and social welfare organizations, business leagues, and social clubs. Nearly all of the law concerning the private inurement doctrine has been

[26]For example, speech by the Director of the Exempt Organizations Division, *Daily Tax Report*, May 21, 2004.

[27]This compliance project is separate from the inquiry into the compensation practices of tax-exempt hospitals (see § 4.5).

[28]See *Tax-Exempt Organizations* § 1.1.

developed in connection with transactions involving exempt charitable organizations. The sole formal sanction for violation of this doctrine is revocation (or perhaps denial of recognition) of exempt status.

The oddly phrased (and thoroughly antiquated) language of the private inurement doctrine requires that the tax-exempt organization be organized and operated so that ''no part of . . . [its] net earnings . . . inures to the benefit of any private shareholder or individual.''[29] The doctrine today means that none of the income or assets of an exempt organization subject to the doctrine may be permitted to directly or indirectly inappropriately benefit an individual or other person who has a close relationship with the organization, when he, she, or it is in a position to exercise a significant degree of control over it. This type of person is known as an *insider*.[30]

Many forms of transactions and arrangements can trigger a transgression of the doctrine of private inurement. The underlying standard in this setting is that the transaction or arrangement be *reasonable*. The type of transaction that is relevant is the payment of compensation. Thus, the private inurement doctrine mandates that the compensation amount paid by most tax-exempt organizations to their insiders be reasonable, as opposed to excessive. Whether an amount (or perhaps type) of compensation is reasonable is a question of fact, to be determined in the context of each case.

The process for ascertaining the reasonableness of compensation is an exercise of comparing a mix of variables largely pertaining to the compensation of others in similar circumstances. In general, reasonable compensation is that amount as would ordinarily be paid for like services by like enterprises under like circumstances. This alchemy—what the intermediate sanctions rules[31] refer to as an accumulation and assessment of data as to comparability—yields the conclusion as to whether a particular item of compensation or a compensation package is reasonable or unreasonable (excessive).

Traditionally, the case law has dictated the criteria to be used in ascertaining the reasonableness of compensation. This approach has come to be known as utilization of the *multifactor test*. The elements—factors—to be used in a particular case can vary, depending on the court. Much of the law in this field is based on case law concerning payments by for-profit corporations to their chief executives. This is because a payment of compensation, to be deductible as a business expense, must be an *ordinary and necessary outlay*; the concepts of reasonableness and ordinary and necessary are essentially identical. Also, the advent of the intermediate sanctions rules has greatly informed this aspect of the law.

The factors commonly applied in the private inurement setting (and similar settings) to ascertain the reasonableness of compensation are the levels of

[29]For example, IRC § 501(c)(3).
[30]See App. C § II D.
[31]See *id*. § II F.

compensation paid by similar organizations (tax-exempt and taxable) for functionally comparable positions, with emphasis on comparable entities in the same community or region; the need of the exempt organization for the services of the individual whose compensation amount and type is being evaluated; the individual's background, education, training, experience, and responsibilities; whether the compensation resulted from arm's-length bargaining, such as whether it was approved by an independent board of directors; the size and complexity of the organization, in terms of elements such as assets, income, and number of employees; the individual's prior compensation arrangement; the individual's leadership and other performance; the relationship of the individual's compensation to that paid to other employees of the same organization; whether there has been a sharp increase in the individual's compensation (a spike) from one year to the next; and the amount of time the individual devotes to the position.[32]

The other body of federal tax law directly pertinent to the matter of executive compensation paid by tax-exempt organizations is the regime known as *intermediate sanctions*, with its emphasis on the *excess benefit transaction*.[33] An excess benefit transaction is essentially the same as a private inurement transaction; in the intermediate sanctions setting, an insider is denominated a *disqualified person*. Exempt charitable and social welfare organizations are subject to this body of law. The sanction(s) imposed in this context are excise taxes, payable by the disqualified person(s) involved.

An excess benefit transaction is a transaction in which an economic benefit is provided by a tax-exempt organization subject to this law (known as an *applicable tax-exempt organization*), directly or indirectly, to or for the use of a disqualified person, and the value of the economic benefit provided by the exempt organization exceeds the value of the consideration (including the performance of services) received for providing the benefit. The difference between the value provided by the exempt organization and the consideration it received from the disqualified person is an *excess benefit*.

An excess benefit transaction includes a payment of unreasonable (excessive) compensation by an applicable tax-exempt organization to a disqualified person with respect to it. The general intermediate sanctions law (including the tax regulations) inexplicably fails to enumerate some or all of the factors to consider in determining whether compensation is reasonable (although they are inventoried above). Nonetheless, in conjunction with the rebuttable presumption as to reasonableness, there is reference to *appropriate data as to comparability*. In this context, relevant data includes compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions, the availability of similar services in the geographical area of the exempt organization, current compensation surveys compiled by independent

[32]See *Tax-Exempt Organizations* § 20.4(b).
[33]See App. C § II F.

firms, and actual written offers from similar institutions competing for the services of the compensated individual.

A third body of federal tax law has some bearing on tax-exempt organizations' compensation arrangements: the doctrine of *private benefit*.[34] The private benefit doctrine is, in many ways, the same as the private inurement doctrine. The most important distinction is that the prohibition against private benefit is not limited to situations where benefits accrue to an organization's insiders. Thus, the private benefit doctrine encompasses compensation paid to persons who are not insiders (or disqualified persons) with respect to the exempt organization. The principal focus of the IRS, however, is on compensation paid by exempt organizations to their top executives, who are insiders, so the private benefit doctrine is rarely applied in connection with compensation issues.

(b) Background

The Exempt Organizations Office of the IRS's TE/GE Division implemented this initiative, managed by an Executive Compensation Compliance Initiative Team. This project used the EOCU and the Data Analysis Unit, which were created in 2004.[35] This project encompassed review of Forms 990 and 990-PF, and related returns, for tax years beginning in 2002. The IRS contacted 1,826 charitable organizations to seek information about their executive compensation procedures and practices; 1,428 were public charities and 398 were private foundations. The EOCU sent compliance check letters to 1,223 charitable organizations whose annual information returns were missing information; this entailed 1,023 public charities and 200 private foundations. An examination phase of this project involved 603 organizations, including 179 entities that that provided unsatisfactory responses to compliance checks; about 10 percent of these examinations remain open.

(c) Methodology

Organizations (1,223) that received these compliance check letters constituted six categories:

1. The 50 public charities with assets of at least $1 million and revenues of at least $5 million that reported ''significant total compensation'' but failed to provide ''complete detailed information'' about that compensation
2. The 100 public charities of all sizes reporting receivables/loans from trustees, directors, officers, and key employees exceeding $100,000
3. The 378 public charities that either answered ''yes'' or failed to respond to the question on the annual return as to whether they participated in an excess benefit transaction

[34]See *id*. § II E.
[35]See § 2.3(d).

4. The 497 public charities that either answered ''yes'' or failed to respond to the question about transactions with disqualified persons
5. The 188 private foundations that did not report any officers' compensation on their returns
6. The 12 private foundations that were contacted regarding loans to officers

(d) Examination Phase

The general purpose of the examination phase of this project was a determination of whether the compensation of disqualified persons was reasonable. During this process, revenue agents also considered the private foundation rules concerning loans to disqualified persons, and the purchase and sale of foundation assets by and to disqualified persons.

This phase involved the following 782 organizations:

- The 100 small public charities (assets of less than $1 million and revenues of less than $5 million) that reported significant amounts of compensation for one or more officers
- The 208 larger public charities (at least $1 million in assets and $5 million in revenues) that reported significant amounts of compensation for one or more officers
- The 97 public charities with completed returns chosen pursuant to a sampling procedure
- The 198 private foundations reporting significant officers' compensation
- The 179 organizations that provided unsatisfactory responses to the compliance checks

(e) Findings

This IRS report contained the following findings:

- Over 30 percent of compliance check recipients were required to amend their annual information returns.
- Fifteen percent of compliance check recipients were selected for examination.
- ''Examinations to date do not evidence widespread concerns other than reporting.''
- Twenty-five examinations resulted in proposed excise tax assessments under IRC Chapter 42, aggregating in excess of $21 million, against 40 disqualified persons or organization managers (over $4 million in connection with public charities and over $16 million in connection with private foundations).

- ''Although high compensation amounts were found in many cases, generally they were substantiated based on appropriate comparability data.''
- Additional education and guidance, and training for agents, are needed in the areas of reporting requirements and use of the rebuttable presumption procedure (the latter for public charities).
- Changes in annual information returns are needed to reduce errors in reporting and provide sufficient information to enable IRS to identify compensation issues.
- This effort utilized ''new compliance contact techniques,'' which have been refined in subsequent projects (e.g., those concerning credit counseling and down payment assistance organizations).

(f) Conclusions

These compliance checks, while uncovering significant reporting errors and omissions in specific areas, particularly in connection with excess benefit transactions and foundation transactions with disqualified persons, indicated that the organizations selected for review generally were compliant with the federal tax law as to compensation paid by tax-exempt organizations. Fifty public charities initially failed to file schedules detailing compensation paid; 10 percent of the private foundations reviewed were referred for examination for this reason. Of the 100 public charities involved in loan-making, 37 were referred for examination; seven private foundations provided loans or pledged collateral to or for the benefit of disqualified persons.

Seventy-seven examinations remain open; 705 have been completed (of the latter, 115 were closed with a written advisory suggesting modifications of future behavior and review by the Review of Operations office). The excise taxes assessed were for (1) excessive salary and incentive compensation; (2) payments for vacation homes, personal legal fees, or personal automobiles that were not treated (reported) as compensation; (3) payments for personal meals and gifts to others on behalf of disqualified persons that were not treated as compensation; and (4) payments to an officer's for-profit corporation in excess of the value of the services provided by the corporation. Eleven percent of the disqualified persons involved in private foundation self-dealing transactions reported the transactions; none did so in the public charity excess benefit transactions cases. Thirteen percent of the self-dealing transactions and 11 percent of the excess benefit transactions were corrected before examination.

As to the rebuttable presumption procedure, (1) 51 percent of the organizations attempted to satisfy all of the three prongs; (2) 54 percent of the organizations commissioned comparability studies, with 97 percent of these studies looking to similar types and sizes of organizations; (3) 97 percent of organizations commissioning comparability studies set compensation within

the range of the comparability data; and (4) 95 percent of disqualified persons recused themselves from discussion and approval of their compensation.

Of the 27 private foundations that were formally examined, 5 percent paid excessive compensation to officers and directors, 86 percent required recusals of officers and directors from discussion and approval of their compensation, 59 percent had written conflict-of-interest policies, 49 percent commissioned a survey to establish compensation, and 92 percent set compensation within the survey range.

(g) Lessons Learned and Recommendations

This report included the following lessons learned and recommendations:

- The size of this project and the ''diverse universe'' created logistical difficulties. Future initiatives of this nature should consider breaking the project into components, such as separating public charities and private foundations.
- Using correspondence as the exclusive method of conducting single-issue examinations for ''factually sensitive and complicated issues,'' such as self-dealing and excess benefit transactions, should be reconsidered. Although it is appropriate to use broad contacts to identify cases to be examined, an up-front field visit or other contact with the examined organization might substantially reduce the volume of records needed to be reviewed and the time spent on the examination.
- Compliance check questions must be ''clear and focused'' so as to produce responses that can be readily analyzed and enable the IRS to select appropriate cases for examination.
- Annual information return compensation reporting needs to be revised to ''facilitate accurate and complete'' reporting. The Form 990 redesign project should focus on reducing the number of places where the same information is required to be reported on the return, providing clearer instructions regarding what needs to be reported, and requesting specific information to identify potential noncompliance areas, such as loans to officers and directors.
- The Exempt Organizations Office (EO) needs to revisit the issue of when penalties should be assessed for filing incomplete annual information returns.
- EO should communicate to the public the most common return preparation errors identified during the compliance checks and examinations.
- EO should further educate the public charity sector about the intermediate sanctions rebuttable presumption and how to satisfy its requirements.

- Future initiatives should focus on the correlation between satisfaction of the rebuttable presumption by an organization and the reasonableness of compensation paid to its disqualified persons.
- EO should change its process for monitoring excise taxes collected for the payment of excess compensation to better distinguish between the different types of excise taxes collected from public charities and private foundations.
- The relatively small percentage of corrections made by disqualified persons before contact by EO illustrates the need for a continued enforcement presence in this area. EO should continue to review compensation issues in more focused projects and should ''pursue baselining general compliance with the compensation rules.''

§ 4.4 POLITICAL ACTIVITIES COMPLIANCE INITIATIVE

The IRS, in 2006, issued a report on its examination of political campaign activity by tax-exempt charitable organizations during the 2004 election campaign.[36] This report reflects the work of the agency's Political Activities Compliance Initiative launched in response to various allegations of participation by charities, including churches, in that campaign.

(a) Law Backdrop

The federal tax law states that tax-exempt charitable organizations[37] must ''not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of or in opposition to any candidate for public office.''[38] This prohibition is framed as an absolute one. Nonetheless, despite many reported incidents of churches and other charitable organizations blatantly engaging in political campaign activity, the IRS rarely enforced this law.[39] As discussed, however, the IRS enforcement attitude radically changed in conjunction with the 2004 elections.[40]

The concept of an *action organization* is used in the political campaign context. An action organization includes an entity that participates or intervenes, directly or indirectly, in any political campaign on behalf of or in opposition to a candidate for public office.[41] An action organization cannot qualify as a tax-exempt charitable entity. Thus, an exempt charitable organization cannot

[36]IR-2006-36.
[37]That is, entities described in IRC § 501(c)(3).
[38]IRC § 501(c)(3).
[39]The most notable exception is reflected in *Branch Ministries, Inc. v. Rossotti*, 40 F. Supp. 2d 15 (D.D.C. 1999), *aff'd*, 211 F.3 d 137 (D.C. Cir. 2000).
[40]See § 4.3(b).
[41]See App. C § IV A.

(without jeopardizing its exemption and/or paying an excise tax) make a contribution to a political campaign, endorse or oppose a candidate for public office, or otherwise support a political candidacy.

Federal tax law levies taxes in situations where a charitable organization makes a political expenditure.[42] Generally, a *political expenditure* is any amount paid or incurred by a charitable organization in any participation or intervention (including the publication or distribution of statements) in any political campaign, on behalf of or in opposition to any candidate for public office. The IRS has, in every instance involving a charitable organization's involvement in political campaign activity, the discretion as to whether to revoke tax-exempt status, impose these taxes, or do both.

In determining whether a tax-exempt charitable organization violated this proscription on political campaign activity, all of the facts and circumstances are considered in determining whether an organization's activities result in political campaign intervention. The IRS issued guidance on topics such as voter education and registration, actions by organizations' leaders personally, candidate appearances, issue advocacy, various business activities, and use of web sites.[43]

(b) 2004 Election Initiatives

In this effort with respect to the 2004 election campaign, the IRS reviewed 166 cases referred to it. This resulted in 68 examinations. Sixty-four other organizations were being audited on this issue. Thus, 132 cases were involved in this project. Twenty-two of these cases were closed without action. Of the remaining 110 cases, as of this time, 82 examinations have been completed, with the following results:

- The IRS is proposing revocation of tax exemption in 3 cases.
- The IRS assessed the political expenditures excise tax in one case.
- The IRS issued written advisories in 55 cases.
- No political campaign intervention was found in 18 cases.
- Other violations of the law of tax-exempt organizations (such as failure to file annual information returns) were uncovered in 5 cases.
- Two other examinations have been completed and are under agency review.
- Twenty-six cases remain in process.

As to the third item, the IRS confines its response to the issuance of a written advisory when an organization engages in prohibited campaign activity that

[42]See *id*.
[43]Rev. Rul. 2007-41, 2007-25 I.R.B. 1421.

was an isolated violation and the organization corrected the violation where possible (such as by recovering funds). In most of these cases, the organization took affirmative steps to preclude future violations of this law.

Violations alleged and determined included the following:

- Charities, including churches, distributing material that encouraged their members to vote for a particular candidate (24 alleged, 9 determined)
- Religious leaders using the pulpit to endorse or oppose a candidate (19 alleged, 12 determined)
- Charities, including churches, criticizing or supporting a candidate on their web site or through links to other sites (15 alleged, 7 determined)
- Charities, including churches, disseminating improper voter guides or candidate ratings (14 alleged, 4 determined)
- Charities, including churches, placing signs on their property that show they support a candidate (12 alleged, 9 determined)
- Charities, including churches, giving preferential treatment to candidates by permitting them to speak at functions (11 alleged, 9 determined)
- Charities, including churches, making contributions to a candidate's political campaign (7 alleged, 5 determined)

Because the IRS found that nearly 75 percent of the organizations examined under this initiative engaged in prohibited political activities, the agency is continuing it for future election periods.

(c) 2006 Election Initiatives

Facing the 2006 election cycle and armed with what it learned during the 2004 election cycle, the IRS announced the following initiatives:

- Distribute expanded educational material and make it widely available early in the 2006 cycle.
- Start its monitoring project earlier in the election year to ensure consistent and timely referral selections and examinations.
- Publicize this project in advance so tax-exempt charitable organizations are not surprised.
- Augment the dedicated and trained team to assure prompt handling of project cases.

This project for 2006 was launched with the issuance of a fact sheet.[44] The IRS considers this fact sheet a ''living document,'' to be revised to take into account ''future developments and feedback.''

[44]FS-2006-17.

This fact sheet summarized the broad prohibition on political campaign activities by exempt charitable organizations, including churches.[45] It inventoried the common ways to have political campaign intervention, noting that some activities must be put to a facts-and-circumstances analysis. The rules pertaining to voter education, voter registration efforts, and get-out-the-vote drives were briefly described.

This analysis noted that leaders of charitable organizations may express themselves on political matters as long as they are speaking for themselves; examples of when this occurs and when it does not were provided. It also stated that these leaders are free to speak about ''important issues of public policy.'' The law as to candidate appearances at charitable organizations' events was summarized, including situations where the candidate is also a government official or other public figure and is speaking in a capacity other than a political candidate.

The analysis summarized the interplay involving the political campaign intervention rules and the issue advocacy rules. Other topics discussed were voter guides, business activities, and web site use in the political campaign context.

(d) 2007 Update

In connection with its issuance in 2007 of a revenue ruling providing formal advice to charitable organizations as to compliance with the federal tax rules prohibiting political campaign involvement by them,[46] the IRS updated the status of its Political Activities Compliance Initiative.[47] In general, the agency has recently experienced a considerable increase in the number of complaints about charitable entities' participation in political activity, leading the IRS to the conclusion that there is a ''continuing high level of noncompliance'' with this body of law.

The IRS reported receipt of 237 referrals concerning alleged violations of these rules during the 2006 campaign season, as contrasted with 166 in connection with the 2004 campaign cycle. Of the referrals pertaining to the 2006 campaign, exempt organizations specialists in the IRS National Office screened out 137 cases. The remaining 100 cases examined by the IRS revealed a range of allegations of campaign intervention, such as direct endorsement of political candidates and statements about campaign issues that favored political candidates. Of the cases closed to date, in conjunction with the 2004 and 2006 compliance initiatives, violations have been found in about two-thirds of the instances. Most of the 2006 cases remain open.

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[45]See App. C § IV A.

[46]Rev. Rul. 2007-41, 2007-25 I.R.B. 1421.

[47]A summary of this report is in Bureau of Nat'l Affairs, Inc., *Daily Tax Report* (no. 106) G-4 (June 4, 2007).

The 2006 political activities compliance initiative includes an IRS review of state political campaign finance databases, in search of political contributions made by tax-exempt charitable organizations. This aspect of the initiative has uncovered nearly $300,000 in these types of contributions, made during the period 2003 to 2005, by 269 charities, including 87 churches. These cases have been converted to examinations (correspondence or field audits), with 92 cases closed and findings of illegal contributions in 65 cases. The IRS has forced refunds of more than $121,000 in these political campaign contributions.

It is the current practice of the IRS to generally only issue written advisories about the law violations, rather than revoke tax-exempt status or impose the excise tax on political expenditures. There have been a few exemption revocations as the result of the 2004 compliance initiative and none to date in connection with the 2006 initiative.

§ 4.5 HOSPITAL COMPLIANCE PROJECT

The IRS, in 2006, initiated its Hospital Compliance Project, the purpose of which is to study tax-exempt hospitals and assess how these institutions believe they are providing a community benefit, as well as to determine how exempt hospitals establish and report executive compensation. Although the IRS published an interim report based on data gathered from questionnaires and annual information returns (Forms 990),[48] the executive compensation component of this project was not addressed in this report inasmuch as examinations in that area are ongoing.

(a) Law Backdrop

Tax-exempt hospitals have attracted the attention of Congress, the Department of the Treasury, and the IRS in recent months. This is not surprising, if only because health-related organizations comprise the largest percentage of exempt charitable organizations and account for about 60 percent of the charitable sector's revenue. Also, there are continuing allegations of a lack of significant difference between exempt and for-profit hospitals, particularly when it comes to charity care and the provision of community benefits.

In addition to meeting the general requirements for tax exemption as charitable institutions, hospitals must satisfy a charity care standard and a community benefit standard. The *charity care standard* requires that an exempt hospital admit and treat patients who are unable to pay either without charge or at rates that are below cost. The *community benefit standard* requires an exempt hospital to operate for the benefit of its community. A hospital that otherwise qualifies for exempt status will meet the community benefit standard

[48]This interim report is the subject of IR-2007-132.

when it has a board of directors comprised of prominent citizens drawn from the community, has a medical staff consistent with the size and nature of its facilities that is open to all qualified physicians in the area, operates a full-time emergency room open to all individuals without regard to their ability to pay, and provides hospital care for everyone in the community that is able to pay the costs themselves, by means of private health insurance, or with the aid of public programs (such as Medicare). Nonetheless, a hospital can qualify for exemption pursuant to the community benefit standard if it does not operate emergency facilities, as long as there are other indications of community benefit.[49]

There is, today, considerable controversy and uncertainty as to the meaning and scope of the concept of *community benefit*. Many of the issues in this context were aired at a hearing before the Senate Committee on Finance, on September 13, 2006, on the subject of community benefit and charity care provided by tax-exempt hospitals. The essence of the testimony presented at this hearing was that the IRS should establish clearer standards for the ascertainment of and reporting by hospitals of community benefit. One approach championed at that hearing involved the guidelines as to community benefit established by the Catholic Health Association, to be used by all exempt hospitals as a template by which community benefit and charity care can be measured and compared to such benefits and care provided by other hospitals.[50] Two of the principal issues in this regard (pitting the Catholic Health Association against the American Health Association) are whether bad debt and unreimbursed amounts paid by hospitals to treat patients should be taken into account in calculating community benefit. It may be presumed that the IRS's compliance check project concerning hospitals will, among other outcomes, bring refinement to identification of the elements that are to be considered in ascertaining community benefit.

(b) Methodology and Process

The management of the Exempt Organizations Division assembled a multifunctional team to plan and implement the hospital compliance project. This team prepared a detailed action plan and project proposal that outlined the objectives of the project, required action items, dates, resources necessary, and potential actions that may be taken to address the identified issues.

In selecting the hospitals to be contacted in effectuation of this project, the IRS queried its files to identify nonprofit, tax-exempt, charitable hospitals. From an initial identified universe of approximately 6,000 entities, the agency selected 544 organizations that it confirmed were hospitals. The IRS, in May 2006, sent compliance questionnaire letters to each of these hospitals, which were of

[49]See *Tax-Exempt Healthcare Organizations*, Chapter 26.

[50]A summary of these guidelines is at 23 *Bruce R. Hopkins' Nonprofit Counsel* (no. 12) 3 (Dec. 2006).

varying sizes and types, and were located in different regions and communities throughout the United States. The agency exercised ''some judgment'' in identifying hospitals that were not ''uniquely available'' in the IRS database. Thus, the resulting sample may or may not reflect the nonprofit hospital sector in general.

Fifty-seven entities were excluded from the original sample of 544 organizations to yield a total net sample of 487 responding hospitals. Forty-six of these hospitals responded that they were not tax-exempt as charitable organizations, generally because they had recently ceased operations and were in the process of winding down or had recently merged with another hospital. Eleven hospitals did not respond to the questionnaire; these hospitals have been ''referred for additional follow-up'' (i.e., examination).

The compliance questionnaire consisted of nine pages and 81 questions.[51] Information was requested regarding the type of hospital and patient demographics, governance, medical staff privileges, billing and collection practices, and categories of programs that might constitute community benefit, such as uncompensated care, medical education and training, medical research, and other community programs conducted by hospitals. Not every hospital answered every question, resulting in a variation in the number of responses. The IRS also derived revenue data from annual information returns and other IRS data bases.

More specifically, this questionnaire contained the following parts:

- The first part requested entity information, such as the organization's name, employer identification number, and date of the most recently filed annual information return.
- The second part requested information to determine whether and how the tax-exempt hospital demonstrates its qualification for exemption as a charitable entity under the community benefit standard; information gathered in this portion of the project is intended to enable the exempt organizations function of the IRS to determine:
  - Whether nonemergency services are available to everyone with the ability to pay
  - Whether the hospital treats Medicare and Medicaid patients in a nondiscriminatory manner
  - How the hospital deals with the uninsured
  - Whether and how determinations of financial responsibility are made
  - The nature and extent of the hospital's charity care policies and, if such a policy exists, how the hospital distinguishes charity care from bad debt

[51]This questionnaire was published as IRS Form 13790.

  - The nature and extent of medical research programs
  - The hospital's participation in partnerships, limited liability companies, other joint ventures, and Subchapter S corporations
  - The hospital's financial relationship with staff members and other closely connected individuals and entities
  - What additional guidance, education, and/or compliance actions are appropriate
- The third part of this questionnaire requested information to identify abuses by tax-exempt hospitals in the form of payment of excessive compensation and benefits to their officers and other insiders; information gathered in this portion of the project is designed to allow the Exempt Organizations function of the IRS to:
  - Address the compensation of specific individuals and instances of questionable compensation practices and procedures.
  - Increase awareness of tax law issues as hospitals establish compensation amounts and types in the future.
  - Learn more about the practices and procedures that hospitals are following as they set compensation.
  - Gauge the existence and effectiveness of the controls employed by hospitals in connection with compensation issues.
  - Learn more about how hospitals report compensation to the IRS and the public on their annual information returns.

There was a high response rate to most of the questions. For example, all 487 hospitals responded to the questions regarding the type of hospital and frequency of board meetings. Over 480 hospitals responded to questions regarding whether they denied medical services to individuals based on insurance coverage, whether they operated an emergency room, medical staff privileges, medical research, medical education and training, uncompensated care, billing and collection practices, and community programs. Many hospitals provided attachments and other information to supplement their responses to certain questions.

General surgical and medical hospitals comprised 89 percent of the respondents, with the remainder providing specialty care (such as psychiatric or rehabilitation services). Inpatients and emergency room patients accounted for 22 percent of the total patients; outpatients amounted to 78 percent of the total patients reported in connection with this project. Forty-six percent of the patients were covered by private insurance; 46 percent of the patients were covered by public programs (Medicare, Medicaid, or other public insurance). Seven percent of reported total patients lacked insurance coverage.

(c) TIGTA Review

During the period the IRS was assessing the information it derived from the questionnaires and writing its interim report, the Treasury Inspector General for Tax Administration (TIGTA) reviewed the purpose and scope of this compliance check project, and inquired as to how IRS management intends to use the results to address potential noncompliance with the law of tax-exempt organizations by exempt hospitals. TIGTA issued a report summarizing and describing the status of the Exempt Organizations Division's tax-exempt hospital compliance project.[52] TIGTA stated that, ''[i]f information gathered in the compliance project shows hospitals are performing only minimum actions to meet the community benefit standard, the function [the Exempt Organizations Division] will consider initiating examinations in this area.'' TIGTA also noted that IRS management may utilize project information to assist in ''differentiating tax-exempt hospitals from for-profit hospitals and in determining whether legislative action would improve'' the ability of the IRS to ''administer [the] tax laws in the tax-exempt hospital industry.''

This TIGTA analysis stated that the Exempt Organizations Division's plan is to issue two reports: an interim report to be made public in mid-2007[53] and a final report, to be issued in September 2008, summarizing the results of this tax-exempt hospitals compliance check project. This final report is expected to provide an update on the community benefit standard since issuance of the interim report, to include a summary of the examination results related to excess compensation, and may include recommendations to improve future compliance by exempt hospitals, recommendations related to educational and outreach efforts needed in these areas, and additional training for Exempt Organization Division personnel in compensation analysis for exempt hospitals.

(d) IRS Interim Report

The IRS, in 2007, released an interim report summarizing information received from 487 tax-exempt hospitals, in response to questionnaires the agency sent in 2006, as to how they provide and report benefits to the community. The agency concluded, in this report, that ''there is variation in the level of expenditures hospitals report in furtherance of community benefit.'' Also, the respondents ''report[ed] similar information in different ways.'' (The report did not address the point that there is no uniform definition of the concept of *community benefit*.[54])

The report noted that ''there is considerable variation in how hospitals report uncompensated care.'' (The term *uncompensated care* was deliberately

[52]2007-10-061 (Mar. 29, 2007).
[53]See § 4.4(d).
[54]See *Tax-Exempt Healthcare Organizations*, Chapter 6.

not defined in the questionnaire because the IRS wanted to learn how the exempt hospital community was applying it.) The report stated that hospitals ''use a range of income and asset criteria to establish eligibility for uncompensated care.'' Hospitals ''also vary in how they measure and incorporate bad debt expense and shortfalls between actual costs and Medicare or Medicaid reimbursements into their measures, and whether they use charges or costs in their measures.''

Uncompensated care accounted for 56 percent of the total community benefit expenditures. Although 97 percent of the hospitals reported that they have a written uncompensated care policy, the respondents did not provide a uniform definition of that term. The treatment of bad debt expense as uncompensated care was mixed, with 56 percent of the hospitals reporting that they did not include bad debt expense as uncompensated care and 44 percent of these institutions reporting that at least some bad debt expense was treated as uncompensated care. Hospitals also varied in reporting uncompensated care on the basis of costs or charges, and the treatment of the difference between gross charges and amounts received for providing care (shortfalls) to Medicare, Medicaid, uninsured, and other patients.

After uncompensated care, the largest categories of expenditures reported by the hospitals as the provision of community benefit were medical education and training (23 percent), research (15 percent), and community programs (6 percent). More than 75 percent of hospitals reported expenditures for producing newsletters and other publications, medical screenings, and public educational programs. Many hospitals reported expenditures to study the unmet health needs of the community (28 percent), immunization programs (40 percent), programs to improve access to health care (54 percent), and other health promotion programs (32 percent).

The report summarized the level of potential reported community benefit expenditures as a percentage of hospitals' total revenue. The mean (average) community benefit expenditures reported by the hospitals, as a percentage of the individual hospital's total revenues, was 9 percent; the median was 5 percent. High percentages of hospitals reported that they did not deny medical services to individuals based on type of insurance or if the patients lacked insurance.

The project team that prepared this interim report recommended that a schedule to the Form 990 be designed to enable exempt hospitals to report their community benefit expenditures. This type of schedule is part of the draft of the revised Form 990 that was released for public comment in June 2007. Indeed, the project team used data from this compliance check project to assist in the crafting of this proposed schedule (Schedule H), which would require reporting (at cost) the charity care and other community benefits provided by the filing organization, and would require information regarding

the organization's charity care policies, revenue profile, bad debt expense, collection practices, and certain other activities.

(e) Future Developments

The project team that developed this interim report is to do the following:

- Analyze the reported data to determine whether differences in reporting, such as the treatment of bad debt and shortfalls as uncompensated care, may be isolated and adjusted to allow more meaningful comparisons among the respondents.
- Engage in additional research and analyze the differences in community benefit expenditure amounts and types to take into account varying demographics, such as rural and urban communities and hospitals.
- Test the reported community benefit amounts and types by conducting data analysis, compliance checks or examinations of individual hospitals, and other means.

§ 4.6 INTERMEDIATE SANCTIONS COMPLIANCE REPORTING

One of the ongoing IRS compliance initiatives, one that is relatively low-key these days, is a project concerning compliance with the intermediate sanctions reporting rules.

(a) Law Backdrop

The intermediate sanctions rules, which focus on excess benefit transactions involving applicable tax-exempt organizations,[55] include a reporting requirement by these organizations. This reporting is to be done by means of the annual information return, which includes this question: ''Did the organization engage in any section 4958 excess benefit transaction during the year or did it become aware of an excess benefit transaction from a prior year?''[56] Should the answer to this question have to be ''yes,'' the exempt organization is required to attach a statement explaining the transaction or transactions. The organization must also report the amount of intermediate sanctions excise tax imposed on organization managers or disqualified persons during the year[57] and any amount of this tax that was reimbursed by the exempt organization.[58]

(b) Compliance Project

Some tax-exempt charitable or social welfare organizations, being applicable tax-exempt organizations and thus required to answer these questions,

[55]See App. C § II F.
[56]For example, Form 990 (2006), Part VI, question 89b.
[57]*Id.*, question 89c.
[58]*Id.*, question 89d.

have, either through inadvertence or deliberate effort to evade provision of the answers, not responded to these questions. When an annual information return, lacking answers to the questions, is received by the IRS, the return is to be forwarded to the Exempt Organizations Division, National Office, where an exempt organizations law specialist will contact the organization, seeking the response(s).

§ 4.7 FUNDRAISING COSTS REPORTING

Another of the ongoing IRS compliance initiatives, one that also is relatively low-key these days, is a project concerning reporting of fundraising costs.

(a) Law Backdrop

There is nothing in the federal tax law that directly correlates an organization's eligibility for tax-exempt status with the types of fundraising it may engage in or the amount of its fundraising expenditures.[59] Nonetheless, this is a subject of considerable interest to states' attorneys general and other state regulators. Thus, there are questions about fundraising on the federal annual information return.

For example, a tax-exempt organization, usually a charitable one, is required to report the gross amount of contributions and grants it received during the reporting year.[60] Exempt organizations also are to report the payment of professional fundraising fees.[61] Exempt charitable organizations, in addition to reporting fundraising fees, are required to report their expenses on a functional basis, which includes the requirement that nearly all expenses must be allocated (when appropriate) to the categories of program services, management and general, and fundraising. Thus, all increments of a charitable organization's fundraising expenses are to be reported on the annual information return.[62] Total fundraising expenses are required to be reported on this return.[63]

(b) Compliance Project

From time to time, IRS reviewers of annual information returns will come across an annual information return that reflects a considerable amount of gifts and grants, and little or no fundraising expense. This anomaly is likely to perplex the reviewer, who may well contact the organization for an explanation. This development probably will not result in an examination but the IRS may

[59]See, in general, *Fundraising*.
[60]For example, Form 990 (2006), Part I, question 1.
[61]*Id.*, Part II, question 30, column (A).
[62]*Id.*, Part II, question 30, column (D).
[63]*Id.*, Part I, question 15.

issue a written advisory on the subject. In some instances, the agency will advise the exempt organization that subsequent annual information returns filed by it will also be reviewed from this perspective (by personnel in the EO Compliance Unit), thus sensitizing the organization to the need (if necessary) for more precision in its reporting on the point.

§ 4.8 TAX-EXEMPT BONDS RECORDKEEPING COMPLIANCE

The IRS launched another of its compliance check initiatives, this one targeting charitable organizations that are engaged in tax-exempt bond financing. This announcement was made at a conference on May 3, 2007.[64]

(a) Law Backdrop

Charitable organizations that are involved in tax-exempt bond financings are required to comply with certain record retention rules. The private-use rules applicable in this context include requirements on subjects such as the cost of issuance of the bonds, public notice and hearings, and record retention. The IRS conducted about 40 examinations of the issuance of 501(c)(3) bonds during fiscal year 2006, to determine the level of compliance with these rules.[65] Inasmuch as the IRS found some lack of compliance, this compliance check project was launched.

(b) Compliance Project

To this end, the IRS will be sending as many as 500 surveys to charitable organizations using exempt bond financing in the coming months. As noted, the focus of this project is on record retention practices.

This initiative apparently evolved out of audits the IRS conducted during fiscal year 2006 of charitable organizations using exempt bond financing. Those audits, however, were undertaken to determine the extent of compliance with the private use rules.

§ 4.9 SUCCESSOR MEMBER INTEREST CONTRIBUTIONS

The IRS has embarked on an examination project, this one inquiring in some depth as to charitable contributions of questionable transactions involving gifts of certain successor member interests. This project is not precisely a compliance check project, although it has some of the characteristics of one.

[64]Bureau of Nat'l Affairs, *Daily Tax Report* (no. 89) G-10 (May 9, 2007).

[65]This examination effort was announced on July 29, 2005 (Bureau of Nat'l Affairs, *Daily Tax Report* (no. 146) G-7 (Aug. 1, 2005)).

(a) Law Backdrop

An excise tax is imposed on most tax-exempt entities and/or entity managers that participate in prohibited tax shelter transactions as accommodations parties. This tax can be triggered in three instances: (1) an exempt organization is liable for the tax in the year it becomes a party to the transaction and any subsequent year or years in which it is such a party; (2) an exempt organization is liable for the tax in any year it is a party to a subsequently listed transaction; and (3) an entity manager is liable for the tax if the manager caused the exempt organization to be a party to a prohibited tax shelter transaction at any time during a year and knew or had reason to know that the transaction is such a transaction.[66]

For this purpose, the term *tax-exempt entity* includes an organization described in the general list of tax-exempt organizations,[67] an apostolic organization,[68] a charitable donee[69] other than the federal government, an Indian tribal government,[70] and a prepared tuition program.[71] The term *entity manager* means, with respect to a tax-exempt *entity*, (1) an individual with authority or responsibility similar to that exercised by a trustee, director, or officer of the organization; and (2) with respect to any act, the person having authority or responsibility with respect to the act.[72]

A *prohibited tax shelter transaction* is of two types: a listed transaction and a prohibited reportable transaction.[73] A *listed transaction* is defined in preexisting law as a reportable transaction that is the same as, or is substantially similar to, a transaction specifically identified by the IRS as a tax avoidance transaction.[74] A *reportable transaction* is a transaction with respect to which information is required to be included with a return or statement because the transaction is of a type that the IRS determines has a potential for tax avoidance or evasion.[75]

The tax regulations[76] established disclosure obligations of taxpayers that participate in reportable transactions, which are further defined in these regulations and include listed transactions that the IRS has determined have a tax-avoidance purpose and generate tax benefits that are subject to disallowance. The IRS, from time to time, identifies (lists) these transactions in notices and other guidance.[77]

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[66]IRC § 4965(a)
[67]IRC § 501(c).
[68]IRC § 501(d). See App. C, I AA.
[69]IRC § 170(c). See App. C, I B.
[70]IRC § 7701(a)(40). See *Tax-Exempt Organizations* § 19.20.
[71]IRC § 529. See *Tax-Exempt Organizations* § 19.17.
[72]IRC § 4965(c).
[73]IRC § 4965(e)(1)(A).
[74]IRC §§ 4965(e)(1)(B), 6707A(c)(2).
[75]IRC § 6707A(c)(1). See § 27.15(d).
[76]That is, regulations promulgated in connection with IRC § 6011.
[77]For example, Notice 2004-30, 2004-17 I.R.B. 828.

A *prohibited reportable transaction* is any confidential transaction or any transaction with *contractual protection* (to be defined in regulations) that is a reportable transaction.[78] A *subsequently listed transaction* is a transaction to which a tax-exempt entity is a party and which is determined by the IRS to be a listed transaction at any time after the entity has become a party to the transaction.[79]

In the case of a tax-exempt entity, the amount of the excise tax imposed with respect to a transaction for a year generally is an amount equal to the product of the highest rate of corporate income tax and the greater of (1) the entity's net income for the year which (a) in the case of a prohibited tax shelter transaction (other than a subsequently listed transaction) is attributable to the transaction, or (b) in the case of a subsequently listed transaction is attributable to the transaction and which is properly allocated to the period as previously described.[80]

This tax is increased in instances where the tax-exempt organization knew, or had reason to know, that a transaction was a prohibited tax shelter transaction at the time the entity became a party to the transaction.[81] The excise tax on an entity manager is $20,000 for each approval of, or other act causing the entity's participation in, a prohibited tax shelter transaction.[82]

In addition to this excise tax regime, there are disclosure obligations imposed on tax-exempt entities.[83] They must disclose the fact of being a party to a prohibited tax shelter transaction and the identity of other parties to the transaction. A taxable organization that is a party to a prohibited tax shelter transaction must disclose to a tax-exempt entity that is a party to the transaction that the transaction is a prohibited tax shelter transaction.[84] Penalties apply for violation of these disclosure rules.[85]

The IRS issued temporary and proposed regulations providing guidance relating to entity-level and manager-level excise taxes with respect to prohibited tax shelter transactions to which tax-exempt organizations are parties, to certain disclosure obligations with respect to these transactions, and to the requirement of a return and time for filing with respect to these taxes.[86] These

[78]IRC § 4965(e)(1)(C).
[79]IRC § 4965(e)(2).
[80]IRC § 4965(b)(1)(A).
[81]IRC § 4965(b)(1)(B).
[82]IRC § 4965(b)(2).
[83]IRC § 6033(a)(2).
[84]IRC § 6011(g)
[85]IRC § 6652(c). This legislation is generally applicable with respect to tax years ending after May 17, 2006, with respect to transactions before, on, or after that date. This excise tax, however, did not apply with respect to income or proceeds that are properly allocable to any period ending on or before August 15, 2006. Tax-exempt organizations that are limited partners in a partnership that has one or more investments that may entail a reportable transaction may be a party to prohibited tax shelter transaction.
[86]REG-139268-06, REG-142039-06; T.D. 9334, T.D. 9335.

regulations, in addition to addressing the definition of the term *tax-exempt entity*, coordinate the term *prohibited tax shelter transaction* with the term *reportable transaction*[87] and define the term *subsequently listed transaction* as a transaction (other than a reportable transaction) to which an exempt entity becomes a party before the transaction becomes a listed transaction. The most significant element of these regulations is the threshold definition of *party* to a prohibited tax shelter transaction, which (1) means an exempt entity that facilitates a prohibited tax shelter transaction by reason of its exempt (or tax-indifferent or tax-favored) status and (2) includes an exempt entity that enters into a listed transaction and reflects on its tax return a reduction or elimination of its liability for federal employment, excise, or unrelated business income taxes that is derived directly or indirectly from tax consequences or tax strategy described in the published guidance that lists the transaction.[88] These proposed regulations also clarify the definition of the term *entity manager*, address the meaning of the phrase *knowing or having reason to know*, define *net income* and *proceeds*, provide rules regarding the manner and timing of the requisite disclosures, and specify the tax forms used to pay the taxes under this regime.

Thereafter, the IRS issued final regulations on the matter of reportable transactions, including a new category of arrangements that must be disclosed, known as *transactions of interest*.[89] The identification of a transaction (or a substantially similar one) as a transaction of interest alerts persons involved with these transactions to ''certain responsibilities'' that may arise from their involvement with the transaction.[90] The first transaction of interest announced by the IRS[91] concerns a transaction in which a taxpayer directly or indirectly acquires certain rights in real property or in an entity that directly or indirectly holds real property, transfers the rights more than one year after the acquisition to a charitable organization, and claims a charitable contribution deduction that is significantly higher than the amount that the taxpayer paid to acquire the rights.[92]

(b) Compliance/Examination Project

The IRS launched an examination program pertaining to charitable contributions of certain *successor member interests*, by means of a prototype letter[93]

[87]IRC § 6011.

[88]Reflecting guidance that was issued previously (Notice 2007-18, 2007-9 I.R.B. 608), the proposed regulations provide that a tax-exempt entity does not become a party to a prohibited tax shelter transaction solely because it invests in an entity that in turn becomes involved in such a transaction.

[89]T.D. 9350, T.D. 9351, T.D. 9352.

[90]IRC §§ 6111, 6112; Reg. § 1.6011-4(b)(6).

[91]IR-2007-143.

[92]Notice 2007-72, 2007-36 I.R.B. 544.

[93]Letter 4290(CG).

and information document request (IDR) that was made public in late October 2007. Essentially, as noted, the transaction in question has a taxpayer acquiring a successor member interest in a limited liability company that owns real estate, transferring the interest more than one year after acquiring it to a charitable organization, and claiming a charitable contribution deduction that is significantly greater than the amount the taxpayer paid to acquire the interest.

This IDR (11 single-spaced pages) includes some pointed questions (inquiries that charitable organizations should ponder, even if they have not received one of these successor-member-interest gifts, when considering whether to accept an unconventional charitable contribution):

- Who initiated contact as to the prospective gift? The IRS wants the names and other information about the individuals involved, as well as copies of relevant written communications (including email).
- Did the charitable organization or any of its trustees, directors, or officers have a business or personal relationship with the donor or a person facilitating the transaction?
- What economic and legal rights did the charitable organization believe it would receive by accepting the successor member interest?
- The IRS wants copies of all correspondence and other documents surrounding the transaction.
- The IRS wants to know about the type and nature of any legal advice the charitable organization received in conjunction with the gift.
- The IRS is inquiring as to whether the organization was asked to agree to not sell or otherwise dispose of the interest for a period of time. If the answer is yes, the IRS wants to know the time period and the reason for the request and agreement, and wants copies of the pertinent documents.
- The IRS wants to know whether the organization was asked to agree or expected to sell or otherwise dispose of the interest to the donor, a person related to the donor, a representative of the donor, or any other specified person. Relevant documents are requested.
- The IRS wants to know what the organization knew about the value of the interest and the valuation method.
- The IRS is asking whether the organization has guidelines for accepting ''unusual'' gifts, such as those of successor member interests. The IRS wants a description and copy of these guidelines, the date they were adopted, who prepared them, and the trustees, directors, and/or officers who approved them.

- The IRS is asking whether the organization's decision to accept the interest was discussed or reviewed by its board of directors or a committee, and wants copies of minutes and other pertinent documentation.
- The IRS wants the organization's reasons for accepting the gift, including ''how and when the organization would derive financial benefit from the interest,'' whether the organization expected to use the interest in a related or unrelated activity, whether the organization expected to realize income from the interest, and the extent the organization understood its ''rights of ownership'' in the interest.
- The IRS wants information about any Form 8283 it received in connection with the gift of the interest.
- The IRS wants information about any contemporaneous written acknowledgment sent to the donor of one of these interests.
- The IRS is asking the organization to describe ''any due diligence'' the organization conducted before receipt of the interest, including ''any assessment you made of the property or obligations against the property.'' Pertinent documents, including the due diligence report, are requested.
- How did the organization report the receipt of the interest on its books and annual information return (Form 990)?
- The IRS wants details as to any disposition of the interest (including any marketing arrangements, the amount received, and the name and address of the organization's lawyer), including any filing of Form 8282.
- Is the organization aware of any ''agreements or arrangements that require any person to keep confidential the intended tax consequences'' of the transaction?
- Is the organization aware of any ''agreements or tax indemnity arrangements with respect to the sales prices or any tax benefits that could arise from these transactions''?
- Was the organization's annual information return, for the year of receipt and/or the year of disposition of the interest, reviewed by an independent accountant or outside counsel?

This is a highly unusual development. This examination program is in the nature of a compliance check project, although the IRS is not using that phrase. In its cover letter, the IRS is asking the organization to provide the answered IDR ''as part of the examination.'' Even the use of a prototype IDR is unique; in the usual compliance check project, a less formal questionnaire is deployed.

CHAPTER FIVE

IRS Tax-Exempt Organizations Examination Procedures

The IRS adopted extensive examination procedures to be followed by its personnel when examining the finances and activities of tax-exempt organizations.[1] (Often, technically, the examination will be said to be of one or more *returns* of an exempt organization.) The focus of these procedures is on selecting exempt organizations' returns as a basis for examinations and on processing claims. (Again, the term *examination* in this context, as defined by the IRS, is a ''review of books, records, and other data to develop all significant issues, to [e]nsure a proper determination of exempt status, qualification, or tax liability where appropriate, and to determine that applicable statutory requirements are satisfied.''[2]) Thus, these procedures focus on the process for ''researching, classifying and selecting returns and claims.''[3]

[1]IRM, Part 4 (titled ''Examining Process''), Chapter 75 (titled ''Exempt Organizations Examination Procedures'') (IRM 4.75). See § 1.1, note 6.
[2]IRM 4.75.4.3 § 4.
[3]IRM 4.75.4.1 § 1. The emphasis in these procedures is on examinations of tax-exempt organizations that are based on examinations of *returns*. An examination of an exempt organization can

Up to this point in the examination process, of course, the exempt organization will have been unaware that the process has been unfolding. Thus, the material in this chapter concerning developments within the IRS leading to the initial contact will be of relevance to the exempt organization and its representatives in understanding how the examination came to be and how the IRS planned for it; all an organization can do with respect to this aspect of the process is to be properly organized and operated.[4] By contrast, the material in this chapter beginning with the initial contact and going forward will be of use to an exempt organization and its representatives in understanding and anticipating what the various phases of the balance of the examination process will (or should) be, and planning their strategy and conduct accordingly.

§ 5.1 DIRECTOR, EXEMPT ORGANIZATIONS EXAMINATIONS

The Office of Director, Exempt Organizations Examinations, has the responsibility for planning, managing, directing, and executing the IRS's nationwide tax-exempt organizations' examinations program; supervising the activities of EO Examination Programs and Review; and overseeing the six exempt organizations Area Offices.[5] This Examinations unit, headquartered in Dallas, Texas, is comprised of exempt organization examination specialists, who are supervised by exempt organizations Group Managers, who in turn are supervised by the exempt organizations Area Manager within a given geographical area.[6]

The Director, Exempt Organizations Examinations, is responsible for:

- Developing overall tax-exempt organizations enforcement strategy and goals to enhance compliance consistent with the TE/GE Division strategy, and evaluating exempt organizations examination policies and procedures
- Regulating and monitoring exempt organizations through examinations of returns, with an emphasis on assuring that exempt organizations continue to meet the statutory requirements for exemption and their other federal tax law responsibilities, including employment taxes
- Coordinating tax law administration and enforcement activities with other federal and state agencies
- Developing and implementing measures for the exempt organizations examination program that ''balance customer satisfaction, employee satisfaction and business results''

be based on more than one return (see § 1.12, note 180). Also, the IRS is of the view that it can examine an exempt organization for a year as to which a return (usually the annual information return) has not been filed (see § 1.7).

[4]See § 3.1.

[5]IRM 4.75.4.5 § 1.

[6]*Id*. § 2.

- Monitoring and evaluating the quality and effectiveness of the exempt organizations examination programs
- Developing and implementing the exempt organizations returns classification and selection process, and the case review and closing processes[7]

§ 5.2 PLANNING, CLASSIFYING, AND SELECTING RETURNS; PROCESSING CLAIMS

Much happens at the IRS before a tax-exempt organization is notified that it has been selected for an examination.[8] From the standpoint of these procedures, the opening concept as to examinations of tax-exempt organizations is the matter of the exempt organizations examination ''planning, [return] classification, and selection process.''[9]

(a) Inventory and Classification System

The IRS developed the Exempt Organizations Returns Inventory and Classification System (RICS); the RICS is an ''automated system that provides users [IRS personnel] access to return and files information related to [the] filing and processing of returns'' filed by exempt organizations.[10] The RICS is used to ''identify and select [exempt organizations] returns which relate to specific types of compliance activities set out in the approved work plan.''[11]

The RICS is used for research, and for the purpose of identifying and selecting exempt organizations' ''return and non-return units'' for examination.[12] RICS is a system that provides users access to return and filer information related to the filing and processing of exempt organizations' returns, functions that support the IRS's examination and research program, and facilitates the selection of exempt organizations' returns with ''conditions that suggest a high potential for noncompliance.''[13]

The primary users of RICS are the IRS employees in the EO Classification unit, which prints selected returns for delivery to the exempt organizations field groups, and the employees in EPP, which uses these returns for purposes of research and analysis.[14] RICS provides access to return information, entity information, filer information, and other administrative and support information, such as the return received date, the statute of limitations date, and ''return

[7] *Id*. § 3.
[8] Or, as some would have it, before an exempt organization has won the audit lottery (see § 3.2).
[9] IRM 4.75.4.2.
[10] IRM 4.75.4.3 § 1.
[11] IRM 4.75.4.2.
[12] IRM 4.75.6.1.
[13] IRM 4.75.6.2 § 1.
[14] *Id*. § 2.

selection information.''[15] RICS permits the exempt organizations returns to be viewed on the screen, printed, sampled statistically, and established on the AIMS and the Exempt Organization Inventory Control system.[16]

The following returns are available on RICS and can be viewed or printed:

- Annual information return—general form (Form 990)[17]
- Annual information return—short form (Form 990-EZ)[18]
- Schedule A, which accompanies both forms[19]
- Unrelated business income tax return (Form 990-T)[20]

Transcribed line items for 12 returns, including the following, are available on RICS for compiling information and for conducting research and/or analysis, but cannot be viewed or printed:

- Employer's quarterly federal tax return (Form 941)
- Annual return of withheld federal income tax (Form 990-PF)
- Income tax return for estates and trusts (Form 1041)
- Income tax return for certain political organizations (Form 1120-POL)
- Return of certain excise taxes on charities and other persons under IRC Chapters 41 and 42 (Form 4720)
- Split-interest trust information return (Form 5227)[21]

RICS allows the ''querying of a database'' as to transcribed return information and related data based on a specified criterion. The user thus has immediate access to the data without having to requisition and review original and/or amended returns. Return information is available based on multi-year criteria; returns can be selected through statistical sampling. The Return Classification Sheet may identify the return's examination potential and other pertinent data such as entity and prior examination history.[22] An individually identified RICS return or a batch of returns may be established on the AIMS and the Exempt Organization Inventory Control system.[23]

The TE/GE Executive Steering Committee appointed the Director, Employee Plan Examinations, as the ''business owner'' of the RICS. This committee also created the RICS Single Point of Contact (SPOC) position.[24] The SPOC

[15] *Id*. § 3.
[16] *Id*. § 5.
[17] See App. C § VII A.
[18] *Id*.
[19] *Id*.
[20] IRM 4.75.6.2 § 7. See App. C § VII C.
[21] IRM 4.75.6.2 § 8. See App. C § VII D.
[22] *Id*. § 9.
[23] IRM 4.75.6.3.
[24] IRM 4.75.6.4 § 1.

position has the responsibility for monitoring the RICS by ''coordinating cross-functionally'' within the TE/GE Division and being the single point of contact for RICS users. The analyst in the SPOC position reports to the RICS business owner.[25]

The RICS Advisory Board (RAB) was created to facilitate coordination with each function and with the RICS programming team. The RAB, which is chaired by the SPOC, has a functional coordinator from each TE/GE Division function, as well as the team leader from the RICS programming staff. The SPOC has the authority to expand, if necessary, the RAB.[26]

The RAB, which is to meet at least quarterly, is responsible for the cross-functional coordination and administration of the RICS, including Request for Information Services prioritization, training, software maintenance, licenses, and other miscellaneous items.[27]

(b) Examination Process

The selection of returns to be examined is determined by the IRS's Examination Planning and Programs (EPP) unit.[28] The EPP unit conducts market segment analyses[29] and develops potential compliance issues. Following identification of these issues, the IRS develops *condition codes* to identify the returns that relate to the particular issue in question.[30]

Once the project and condition codes are produced, the data is given to the Classification unit for return retrieval. This unit utilizes the RICS system to ''pull the necessary returns to satisfy the project needs.'' These returns are required to have at least 18 months remaining in relation to the applicable statute of limitations.[31]

As these returns are received by the Classification unit and a ''full account is accomplished'' on the AIMS, the returns are ''transferred to the examination group that covers the geographic area where the organization is located.''[32] Thereafter, the examination group ''conducts the audit on the organizations for which the returns were pulled.''[33]

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[25] *Id*. § 2.
[26] IRM 4.75.6.4 § 3.
[27] *Id*. §§ 4, 5.
[28] IRM 4.75.4.6 § 1.
[29] See § 4.2.
[30] IRM 4.75.4.6 § 1. The RICS condition codes are codes that ''identify specific data that [are] needed to select the returns that fit a project issue'' (IRM 4.75.4.3 § 2).
[31] IRM 4.75.4.6 § 1.
[32] IRM 4.75.4.6 § 3.
[33] *Id*. § 4.

(c) Claims Processing

Claims are received and processed at the IRS service center in Ogden, Utah. If a claim is received by any other unit of the TE/GE Division, it will be sent to this service center for processing.[34] Claims that cannot be processed by the service center are to be sent to the Classification unit. All claims are to have an AIMS account on the Integrated Data Retrieval System (IDRS) when received in the Classification unit; if such an account does not exist, the classification group will establish one.[35] The Classification unit will record the claim on the IRS claims database and establish it on the EOIC system.[36]

(d) Joint Committee Claim Cases

A case that involves a request for the return of overpayment of $2 million or more must be processed and sent to the appropriate exempt organizations examination group.[37] Once the examination group completes its examination and prepares its report, the case file will be sent to the Joint Committee on Taxation for review.[38]

§ 5.3 INFORMATION ITEMS

An IRS examination of a tax-exempt organization will be predicated, by definition, on the agency's acquisition and review of one or more items of information about the organization. The IRS has procedures pursuant to which information items received by the Exempt Organizations Division are evaluated and preserved for this purpose. The IRS states that these procedures are ''designed to ensure that [the Division] operates in an unbiased and appropriate manner and to protect against impropriety and undue influence in its compliance programs.''[39] The IRS observes that the Director, Exempt Organizations Examinations, has ''broad discretion to undertake coordination and to develop procedures to create an active and effective referral program.''[40]

(a) Types and Sources

From the IRS's perspective, there are two types of *information items*:

1. A document or other communication, including an electronic communication, received by the Classification unit from a source outside the IRS,

[34]IRM 4.75.4.7 § 1.
[35]*Id*. §§ 2, 3.
[36]*Id*. § 4A.
[37]IRM 4.75.4.7.7.
[38]IRC § 6405(a).
[39]IRM 4.75.5.1 § 1.
[40]*Id*. § 2.

which alleges possible noncompliance with a tax law on the part of a tax-exempt organization, taxable entity, or individual[41]

2. A document prepared by an IRS employee (*referral*) and forwarded to Exempt Organizations Classification, which identifies current or potential noncompliance discovered during either the processing of an assigned case or at any other time in the performance of official duties[42]

Information items may be derived from a variety of sources, including:

- Exempt Organizations Division employees conducting examinations or processing determinations
- Other IRS ''functional areas''
- The media
- Other federal agencies, such as the Departments of Labor, Housing and Urban Development, and Justice
- State and local government agencies and officials
- Members of the exempt organizations community
- The public
- Members of Congress[43]

(b) General Procedures

Exempt Organizations Classification is expected to ''act promptly'' on information items. Classifiers are to begin evaluating information items within 30 days of the date of their receipt in the Classification unit. Information items classified as having ''examination potential'' are to be established on the AIMS and the EOIC system within 90 days of receipt.[44]

Notwithstanding this admonition for prompt action, the IRS has a ''fast-track'' procedure by which referrals determined to have ''priority'' are identified and expedited. Referrals identified for fast-tracking are to be assigned to a classifier immediately and evaluated on a ''next-case'' basis. A classifier

[41]This listing by the IRS also includes a reference to a political organization, which is a tax-exempt organization (IRC § 527(a)).
[42]IRM 4.75.5.2.
[43]IRM 4.75.5.3. The IRM notes that the Executive Branch of the federal government is prohibited from influencing taxpayer audits and other IRS examinations, and requires the reporting of violations to the Treasury Inspector General for Tax Administration (IRC § 7217) (*id*.). See § 2.1(b). The IRM also notes that any IRS employee receiving an information item originating from the White House or other Executive Branch office should immediately report the item to his or her supervisor or to the Director, Exempt Organizations Examinations, for a determination of the applicability of IRC § 7217 and ''necessary action'' (*id*.).
[44]IRM 4.75.5.4 §1.

is to review all incoming information items daily and identify those requiring expeditious handling. All Exempt Organizations Referral Committee[45] cases are included in this fast-track procedure, along with ''allegations of fraud with supporting documentation and certain critical initiatives and projects.''[46]

A classifier is required to make one of the following determinations as to an information item:

- It has examination potential,
- It lacks examination potential,
- It should be considered in a future year,
- Additional information is required to make a decision, or
- The item should be referred to the Exempt Organizations Referral Committee.[47]

Notwithstanding the foregoing, the following information items are required to be referred to the EO Referral Committee:

- Those evidencing or alleging political or lobbying activities,
- Those evidencing or alleging financial transactions with, including contributions to, individuals or organizations with known or suspected terrorist connections,
- Those containing evidence or allegations involving a church,
- Those involving ''high-impact'' issues (such as those pertaining to a case that may result in media attention),
- Those involving ''sensitive'' cases (such as those involving information submitted by an elected official (other than members of Congress or officials in the federal Executive Branch)),
- Those submitted by a member of Congress or a member's staff person, or
- Those involving other factors indicating that review by the EO Referral Committee ''would be desirable for reasons of fairness or integrity.''[48]

Copies of information items subject to EO Referral Committee review are required to be mailed to the members of the committee by the fifth day of each month; the committee is to meet by the 17th day of each month to discuss and classify the items. Minutes of these meetings are required to be faxed to the

[45]See § 5.3(d).
[46]*Id*. § 2.
[47]*Id*. § 3.
[48]*Id*. § 4.

Manager, EO Classification, within five business days of the meeting. These minutes are to document the issues and reasons for selection or nonselection for each information item. EO Classification is required to enter this information on the ''referral database.''[49] The EO Referral Committee is expected to review the referred information items using the *reasonable belief standard*.[50]

(c) Classification Procedures

EO Classification maintains a database of all information items received by the unit. This database is the source of an EO Information Item Tracking Sheet, which is attached to the original of the information item and remains with it until ''all actions are completed.'' Each IRS employee handling an information item is required to enter the ''appropriate information'' on this tracking sheet, and document the dates and actions taken with respect to the item.[51]

When an information item is initially received in EO Classification, a management assistant is required to do the following:

1. Perform IDRS research.
2. Establish the item on the database with the name and address of the referred entity, the name and address of the informant,[52] a source code, the date the IRS received the item, and the date EO Classification received the item.
3. Prepare and mail an acknowledgment letter to one or more of the informants.
4. Assign the referral to a classifier.

The classifier is required to review the information item and conduct ''appropriate research'' to determine whether the item has ''examination potential.'' The procedures state that it is ''imperative'' that ''qualification issues'' as well as return information be considered. In certain instances, a classifier may determine that the referred entity should be considered for examination in a subsequent year (such as because a transaction has occurred in a tax year that has not ended[53] or a determinations specialist has recently granted recognition of tax exemption ''believing that the organization may not operate as their [*sic*] application stated''). If this occurs, the referral is ''closed

[49] A Referral Control Number is automatically assigned to each information item, in ''sequence of input,'' when it is added to the referral database.
[50] *Id*. §§ 5, 6. Also IRM 4.75.5.5 § 5.
[51] IRM 4.75.5.5 § 1. This documentation is to be done on Form 5464-A (''EP/EO Case Chronology Record'').
[52] An informant may be entitled to an award, in which case the information item will include a Form 211 (''Application for Reward for Original Information''). The classifier is required to retain a copy of this form and mail the original to the appropriate campus (following the procedures in IRM 25.2.2) (IRM 4.75.5.5 § 4).
[53] See § 1.7.

from the database'' and filed ''by suspense date'' so that it may be considered at the designated time.[54]

If an examination is warranted, the classifier is expected to document the reasons for the selection of the tax-exempt organization on the tracking sheet and prepare the source document to ''establish the return(s)''[55] on the AIMS and the EOIC. These procedures are to be followed irrespective of whether the examination is a complete one or is one of limited scope.[56] If an examination is not warranted, the classifier is required to document the reasons for ''nonselection'' on the tracking sheet.[57]

Also, if an examination is warranted, the management assistant is required to (1) establish the matter on the AIMS and EOIC system, ''with a V freeze code'' on the AIMS account, to ensure that the return will be routed through the EO Classification unit at closing; (2) either print a copy of the appropriate return(s), using the CDs provided by the Ogden Campus or, when the document(s) are not available on CD, request the original return(s) from the Ogden Campus; (3) update the information item in the referral database; (4) print the tracking sheet and attach it to the information item; (5) copy and retain the copy of the tracking sheet and information item, and file these documents in ''open examination files''; and (6) forward the ''established return(s)'' to the appropriate EO group.[58] If an examination is not warranted, the management assistant is expected to update the referral database using the information provided by the classifier and file the referral in ''closed referrals.''[59]

The tasks necessary to process information items are to be completed as follows:

- The initial research, creation of the database record, the acknowledgment letter to third parties, and the printing of the tracking sheet are to be completed by the 21st day after receipt of the information item in EO Classification.
- The information item is to be assigned to a classifier by the 30th day after receipt.
- The classifier is to make a determination and prepare the appropriate guidance for ''establishing'' an examination case (if there is to be an examination) by the 60th day after receipt.

[54]IRM 4.75.5.5 § 3.

[55]A likely combination in this context would be the filing, by a tax-exempt organization, of an annual information return (Form 990) and an unrelated business income tax return (Form 990-T). See App. C § VII A, B.

[56]IRM 4.75.5.5 § 6.

[57]*Id*. § 8.

[58]*Id*. § 7. The information to be forwarded to this group will also include current research, the referral tracking sheet, and the original information item.

[59]IRM 4.75.5.5 § 9.

- The decision is to be documented on the referral database by the 75th day after receipt.
- For items selected for examination, AIMS and EOIC accounts are to be established and the item is to be ''assignment ready'' by the 90th day following receipt.[60]

Field groups or Mandatory Review, if applicable, is to ''close'' all information item–generated cases to EO Classification after completion of the ''examination or survey action.''[61] The EO Classification unit is to capture the examination results on the referral database, remove the freeze code, and forward the results to the closing unit on AIMS and EOIC. An updated tracking sheet is to be printed; a copy of it is to be filed with the return and a copy filed with the closed referral in EO Classification.[62] IRS operating divisions are to forward all EO information items to the Classification unit.[63]

(d) Referral Committee

The EO Referral Committee, which has at least three members, is comprised of IRS employees who are technically experienced in the law of tax-exempt organizations, such as senior examiners, return classification specialists, group managers, or area managers. Each member of this committee serves for 12 months on a staggered schedule to maintain ''expertise and continuity'' within the committee. The Director, Exempt Organizations Examinations, is to issue a memorandum soliciting volunteers 30 days prior to the start of the assignments, which commence on February 1, June 1, and October 1.[64] This committee's responsibility is to consider, in a ''fair and impartial manner,'' whether information items have ''examination potential.'' The committee may determine that additional factual information is required before a decision can be made as to examination potential of an item.[65]

In considering whether an information item has examination potential, the members of the EO Referral Committee are required to determine whether the information item establishes a reasonable belief that further action by the IRS is warranted. If this committee determines that an information item meets that standard, the item will be referred for examination; otherwise, it will not be

[60] *Id*. § 10.
[61] *Id*. § 11.
[62] *Id*. § 12. An examination may yield information about entities other than tax-exempt organizations. In that event, EO Classification is to forward a TE/GE Referral Information Report (Form 5666) to the Planning and Special Programs unit for the ''territory servicing'' of the taxpayer (i.e., the Small Business and Self-Employed Division, the Wage and Investment Division, or the Large and Mid-Size Business Division) (*id*. § 13). See § 2.2, text accompanied by notes 27–29.
[63] *Id*. § 14.
[64] IRM 4.75.5.6 § 1.
[65] *Id*. § 2.

referred.[66] *Reasonable belief*, for this purpose, means that the information item, ''when considered fairly and in light of other reliable information, if available, demonstrates that a violation of the Federal tax laws may have occurred or appears likely to lead to the discovery of a violation upon examination.'' In making this determination, EO Referral Committee members are ''expected to use their experience, judgment, and concern for fairness.''[67]

The EO Referral Committee reviews all information items concerning organizations claiming to be churches.[68] The committee is required to determine if the information supports a reasonable belief that the organization may not be tax-exempt as a church, may be carrying on an unrelated business, or may otherwise be engaged in activities subject to a federal tax, or that an intermediate sanctions tax[69] may be due from a disqualified person with respect to a transaction involving a church.[70]

§ 5.4 OTHER IRS PREEXAMINATION PROCESSES

The IRS developed an elaborate system for acquiring information about tax-exempt organizations, using this information to prioritize and develop examination cases and to provide examining agents guidance for commencing and properly handling an audit.

(a) Recordkeeping System

The EO Classification unit is required to maintain a recordkeeping system for all information items within the jurisdiction of the Exempt Organizations Division. This system is to track receipt and disposition of all information items received, properly identify the source of all information items,[71] and ensure that all decisions relating to examination case selection or nonselection, including the evaluation and disposition of all information items and source documents, irrespective of merit, are documented and associated with the information item record file.[72]

This information item recordkeeping system is to allow IRS management to track all information items to:

- Determine the date the item was received by the IRS and the EO Classification unit.

[66] *Id*. § 3.
[67] IRM 4.75.5.7.
[68] See § 6.3.
[69] See App. C § II F.
[70] IRM 4.75.5.8.
[71] This system utilizes the AIMS source codes.
[72] IRM 4.75.5.9 § 1.

- Document the movement of an item through the system, including the source of the item, who made the decision to examine or not examine, the rationale for this decision, how the decision was implemented, and the location of the item at the time.
- Document the disposal codes, issue codes, and survey actions after closure of examinations resulting from referrals and information items.[73]

EO Classification is to retain all information items and source documents regardless of whether the item results in an examination. Information items and related documents, and tracking sheets, are to be stored in a ''secure, systematic, and retrievable manner'' for three years from the last action date on the file (e.g., the date the item was classified and closed as not selected or the date the examined return was closed through EO Classification).[74]

(b) Case Assignment Guide

The IRS developed the EO Case Assignment Guide (CAG), the primary purpose of which is to provide a ''quick and reliable tool'' for a classifier to use in assigning a grade to a case and a group manager to use in assigning work that is generally commensurate with the grade level of expertise of the examiner[75] assigned to the case.[76]

Group managers are responsible for paying ''strict attention'' to their case grading practices to ensure that the grade assignment is ''closely tied'' to the classification standard, generally assigning cases consistent with the examiners' grade level, and keeping ''developmental assignments'' to no more than 20 percent of an employee's time.[77] If a group manager is of the view that application of the CAG does not yield the appropriate case grade, the manager is to use ''sound judgment'' in grading the case.[78] To the extent a questionable case resembles one of these descriptions (taken in their entirety), a group manager may rely on these descriptions as both a case assignment tool and a check on grades assigned using the CAG criteria.[79] The group manager is responsible for ensuring that the final case grade is accurate.[80]

CAG criteria are derived from ''position classification factors'' listed in the Office of Personnel Management (OPM) standards. Work graded, using the CAG, reflects ''complexity and impact'' equivalent to those specified in

[73] *Id*. § 2.
[74] *Id*. §§ 3, 4.
[75] The procedures define the term *examiner* as the tax-exempt organizations agent that is assigned to work the examination case (IRM 4.75.7.2 § 1 C); an *examination case* is the ''primary return for one year plus other returns involving interrelated interest and/or transactions (*id*. § 1A).
[76] IRM 4.75.7.1.
[77] IRM 4.75.7.3 § 1.
[78] *Id*. § 2.
[79] *Id*. § 3.
[80] *Id*. § 4.

the OPM standards for that grade, assuming normal supervision. Income and assets reported on the return are used to determine the case grade of tax-exempt organizations examination cases based on the type and size of the organization. Team Examination Program case grading criteria are separately stated.[81]

The IRS classifies tax-exempt organizations examination cases by means of four categories: GS-9 cases, GS-11 cases, GS-12 cases, and GS-13 cases:

1. *GS-9 cases*. Cases are graded as GS-9 cases when there are ''few and less complex'' issues. These cases may be examined pursuant to the Office/Correspondence Examination Program.[82] *Office interview examinations* are conducted when the organization's gross receipts are less than $100,000 and there are one or more issues that cannot be verified by correspondence. *Correspondence examinations* are conducted when there are no more than three issues and are generally less difficult than office interview examinations.[83]
2. *GS-11 cases*. Cases graded as GS-11 are those in which experience is necessary to determine and resolve issues applying established laws, precedents, and ''methods frequently used and generally applicable''; complicating features may be present that involve controversy or a number of interrelated issues; and/or the impact of decisions may extend beyond the organization or metropolitan area because of the scope of activities or the nature of the issues.[84]
3. *GS-12 cases*. GS-12 cases are those with major issues involving difficult or complex legal or accounting problems and require extensive investigation to resolve problems. As illustrations of this standard, (1) direct precedent is not available or appropriate, requiring the examiner to ''adapt standard methods'' and interpret laws; (2) complications involving interrelated questions of a factual, financial, legal, or accounting nature are present; (3) resolution of the issues may involve controversy due to interpretation or adaptation of precedents that are not directly related; and (4) the substantial impact of decisions may affect a larger organization of regional or national stature or possibly ''arouse public attention.''[85]
4. *GS-13 cases*. GS-13 cases involve major issues, the resolution of which is significantly affected by the lack of precedent or the presence of conflicting precedent. Therefore, investigation of the issues requires

[81]IRM 4.75.7.4. See, e.g., § 1.6(c).
[82]The IRS refers to this program as embodying the ''office interview and correspondence examination technique'' (IRM 4.75.7.2 § 1B). See § 1.6(b).
[83]IRM 4.75.7.4.1.
[84]IRM 4.75.7.4.2.
[85]IRM 4.75.7.4.3.

> ''ingenuity''; resolution of the issues requires ''consideration, tact, and discretion''; the complexities involved ''necessitate a high degree of experience and sophistication''; the impact of decisions may be substantial and involve large sums of money or large numbers of people, with the possibility of ''widespread public attention''; and complications could occur, involving ''intricately related major issues'' or unusual issues with ''conflicting or nonexistent precedents.''[86]

The procedures provide that ''proper use'' of the CAG will ensure that accurate data is available ''on workload'' for financial planning and grade structure changes, facilitate the ''selective assignment'' of higher-level work for developmental purposes, aid in the analysis of ''position management effectiveness,'' and provide information relative to the appropriateness of position classifications and other management and personnel information needs.[87] The procedures also state that the CAG should not be used in evaluating an examiner's performance or to classify examiners' positions. For example, the procedures continue, the CAG should not be considered a predictor of the appropriate overall grade level for the position of employees doing work assigned in accordance with it or viewed as superseding OPM standards.[88]

Assignment of higher- or lower-level cases for short periods of time to provide developmental opportunities or to meet ''specific operational needs'' is not to affect the grade level of an examiner's position.[89] If a developmental or priority assignment is above the grade level of the examiner and is completed under closer-than-normal supervision or supervisory instructions, the assignment may be considered consistent with the examiner's grade.[90]

The CAG is general and establishes a probable grade level that is subject to change by the group manager or classifier. The CAG grade can be upgraded or downgraded.[91] Cases may be upgraded if one or more of the following items materially increases the complexity of the case:

- Difficulty in classifying the organization's tax-exempt purpose.
- Unrelated debt-financed income[92] is an issue.
- An organization that is exempt as a social club has substantial gross receipts from the public (nonmembers) or investments.[93]

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[86]IRM 4.75.7.4.4.
[87]IRM 4.75.7.5 § 1.
[88]*Id*. §§ 2, 3.
[89]*Id*. § 4.
[90]*Id*. § 5.
[91]IRM 4.75.7.6 § 1.
[92]See App. C § IX G.
[93]*Id*. § I N.

- Termination of or other changes to private foundation status.[94]
- Unusually complex private foundation issues.
- Denials, revocations, terminations, modifications, or reinstatement of exempt status.
- Changes in purposes or activities of the organization requiring a termination or redetermination.
- Extensive research and/or interpretation of the law, regulations, and court decisions.[95]
- Unrelated business income or operations (complex allocation problems).[96]
- Organization is known and/or operates on an international, national, or regional basis.
- A determination regarding an organization's exempt status is of concern to many individuals (political and public figures).
- Controversial issues are present that are of interest to the public.
- Church issues.[97]
- Unusually large payments to officers, employees, and professionals.
- An organization with substantial receipts from sources other than members seeking exemption or is exempt as a benevolent life insurance association, mutual ditch or irrigation company, mutual or cooperative telephone company, or like organization.[98]
- Allocation of substantial amounts to legislative activities or political purposes.[99]
- Valuation problems requiring the assistance of an engineering specialist.
- Affiliated organizations, multiple entities, or related interests (taxable or nontaxable).
- Large refund case (over $100,000).
- Fraud referrals (accepted or rejected).
- Terminations and/or mergers.
- Group exemption rulings.[100]

[94] *Id*. § V.
[95] The procedures observe that laws and regulations may be ''ambiguous, in a proposed state, or little precedent exists'' (IRM 4.75.7.6).
[96] See App. C § IX G.
[97] See Chapter 6.
[98] See App. C § I R.
[99] *Id*. § III, IV.
[100] *Id*. § VI B.

- Complex accounting system.
- Cases involving transferee liability.
- Cases involving compliance by private schools with the IRS guidelines and recordkeeping requirements as to racially nondiscriminatory policies concerning students.[101]

The manager can lower a case grade for good cause, such as the fact that anticipated complexities failed to develop. The basis for the change in grade must be fully documented in the case file.[102]

Group managers are required to provide guidance in limiting the scope of an examination where appropriate. A decision to limit the scope of an examination must be documented in the case file.[103]

Consideration of the Tax Exempt Quality Measurement Standards (TEQMS) must be documented in limited scope examinations.[104] To meet the TEQMS, the following items must be considered during the preplanning of the examination of an annual information return (Form 990): the balance sheet; Form 990, Part IV; large, unusual, and questionable income items; large, unusual, and questionable expense items; and the package audit requirements.[105]

(c) Preexamination Guidelines

The procedures provide Exempt Organization Division examiners with guidelines and procedures for analyzing general program returns assigned for examination, determining whether the returns should be examined, and preparing an examination plan or surveying the returns.[106] These guidelines are inapplicable to the examination of returns included in the Team Examination Program,[107] returns filed by political organizations,[108] or employment tax returns.[109] Performance of these preexamination procedures is intended to ensure that the examiner identifies all potential issues disclosed on the return, sets the proper scope for the examination, asks appropriate questions during the initial contact with the exempt organization, and prepares a ''clear, concise, and appropriate'' initial information document request.[110] Adherence to these guidelines and procedures also is intended to ensure that an examination

[101]IRM 4.75.7.6 § 2. See App. C § I D.
[102]*Id*. § 3.
[103]IRM 4.75.7.7 § 1.
[104]IRM 4.75.7.7 § 2.
[105]*Id*. § 3.
[106]IRM 4.75.10.1 § 1.
[107]See § 1.6(c).
[108]See App. C § VII B.
[109]See IRM 4.23. IRM 4.75.10.1 § 2. The guidelines and procedures for excise tax returns other than returns pertaining to tax-exempt organizations excise taxes are in IRM 4.24.
[110]IRM 4.75.10.1 § 3. See, e.g., § 1.4.

meets the standards constituting a quality preexamination as outlined in the TEQMS.[111]

(d) Examination Objectives

The primary objectives, from the standpoint of the IRS, for examination of a tax-exempt organization are to determine if:

- The organization is organized and operated in accordance with its exempt purpose(s) and should continue to be recognized as an entity that is exempt from federal income taxation.
- The appropriate return (Form 990, 990-EZ, 990-PF, or 5227) is complete, correct, and contains all ''public information.''
- The exempt organization has properly filed all other returns and forms for which it is liable, such as:
  - Unrelated business income tax return and proxy tax return (Form 990-T)
  - Employer's annual federal unemployment tax return (Form 940)
  - Employer's quarterly federal tax return (Form 941)
  - Wage and tax statement (Form W-2)
  - Annual summary and transmittal of U.S. information returns (Form 1096)
  - Miscellaneous income return (Form 1099-MISC)
  - Monthly tax on wagering return (Form 730)
  - Occupational tax and registration return for wagering (Form 11-C)
  - U.S. income tax return for certain political organizations (Form 1120-POL)
- The exempt organization is liable for taxes and, if so, the correct amount of the tax, namely:
  - Unrelated business income tax[112]
  - Federal Insurance Contribution Act taxes[113]
  - Federal unemployment tax[114]
  - Transactions by private foundations[115]
  - Transactions by Black Lung Benefit Trusts[116]

[111]IRM 4.75.10.1 § 4.
[112]IRC §§ 511–514. See App. C § IX H.
[113]IRC §§ 3101, 3111.
[114]IRC § 3301.
[115]IRC §§ 4941–4948. See App. C § V F.
[116]IRC § 4953. See App. C § I Y.

- Taxes in connection with lobbying activities by public charities[117]
- Taxes in connection with legislative activities by political organizations[118]
- Taxes in connection with political campaign activities by public charities[119]
- Intermediate sanctions taxes[120]
- Taxes in connection with gaming activities[121]
- Taxes on disqualified benefits from funded welfare benefit plans.[122]
- Proxy taxes in connection with certain lobbying and/or political activities[123]

(e) Beginning of Examination Process

The examination process (still solely within the confines of the IRS) begins with the assignment of the ''case/returns'' to the examiner.[124] On receipt of the case file, the examiner is to review it, including the return(s), schedules, elections, extensions, or any other documents attached to the return(s), in order to determine whether to survey the return or conduct an examination. Some of the factors the examiner is to consider in this regard are the examination potential, the statute of limitations, the examination cycle, any conflict of interest, any consecutive examinations, repetitive examinations, and the prior examination record.[125]

(f) Group Manager Involvement

The procedures state that the group manager's involvement in an examination may be appropriate at any time, from the preexamination stage to the final steps of resolving unagreed issues. Examiners are cautioned to not wait until an examination becomes a ''problem'' before asking for managerial assistance. Group managers are encouraged to be proactive in dealing with their employees' examination cases to avoid problems.[126]

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[117]IRC §§ 4911, 4912. See App. C § III A.
[118]IRC § 527(f). See App. C § IV D. This list of taxes does not include imposition of the political organizations tax on other tax-exempt organizations.
[119]IRC § 4955. See App. C § IV A.
[120]IRC § 4958. See App. C § II F. This is an interesting entry, in that these taxes are imposed on tax-exempt organizations only in the rare instance they are disqualified persons with respect to applicable tax-exempt organizations.
[121]IRC § 4401.
[122]IRC § 4976.
[123]IRC § 6033(e)(2). IRM 4.75.10.4.
[124]IRM 4.75.10.5 § 1.
[125]*Id*. § 2.
[126]IRM 4.75.10.6 §§ 1–3.

Instances in which a group manager should become involved in an examination of a tax-exempt organization include assignment or reassignment of a case, the organization requests transfer of an examination to a location outside the group's normal travel area, the examiner determines that the examination should be transferred to another location, survey of a return after assignment, initiation of an examination of a return with less than 12 months remaining on the statute of limitations or where the examination cannot be expected to be completed within the current examination cycle, the scope of an examination is limited or expanded, prior or subsequent years are selected for examination, related returns are added to the examination, exempt organization ''procrastination'' is delaying examination actions, the time span set for the examination is ''unusually lengthy,'' an unusual amount of time has been charged to the examination, organization complaints are received, and a closing conference on a potentially unagreed case is held.[127] Group mangers are required to document their actions in a case. These actions include workload reviews, case reviews, on-the-job visits, discussions with an examiner, and discussions or conferences with a representative of a tax-exempt organization.[128]

(g) Statute of Limitations

The procedures state that the ''protection of the statute of limitations is a high priority for all [IRS] employees.''[129] This admonition does not mean what it literally states; this is a call to all of the agency's employees involved in tax-exempt organizations examinations (and, for that matter, all others) to act in such a way—*protect*—so as to prevent the running of the statute of limitations against the government. The examiner is primarily responsible for properly identifying the statute of limitations period in order to protect the government's interests. The examiner is responsible for protecting the statute of limitations on:

- Any assigned returns,
- Any prior or subsequent-year returns if the adjustments to the examination year create adjustments for the prior or subsequent year and an examination of the prior or subsequent year is justified,
- Any income, employment, or excise tax returns filed or required to be filed by the organization if an examination of an annual information return may result in an adjustment to the tax liability on these returns, and/or

[127] *Id*. § 4. The procedures note that if the group manager is not involved in the initial closing conference, the tax-exempt organization being examined must be offered a managerial conference before the case is ''closed unagreed.''
[128] IRM 4.75.10.6 § 5.
[129] See § 3.11.

- Any income or excise tax returns filed or required to be filed by related individuals or entities, if the examination of an annual information return may result in an adjustment to the tax liability on these returns.[130]

When a case is assigned, the examiner is required to verify the statute of limitations date and ensure that there is ''sufficient time to conduct a quality audit.'' To verify the correct statute of limitations date, the examiner is expected to review the following sources, as appropriate, and document the case file accordingly: the examination return charge-out form (Form 5546), the IDRS, the AIMS, the received date stamped by the campus on the face of the original return, and the postmark date on the envelope in which the return was mailed, if attached.[131]

The examiner may not initiate an examination of a tax-exempt organization's return where there is less than 12 months remaining in the statute of limitations period or where it cannot be expected that the examination will be completed within the current examination cycle, unless the failure to conduct an examination would result in ''serious criticism'' of the IRS's administration of the tax law, inconsistent treatment of similarly situated organizations, establishment of a precedent that would seriously hamper subsequent attempts by the IRS to take corrective action, or the loss of a substantial amount of tax revenue. If the examiner determines that an examination should be initiated in these circumstances, approval by the group manager is required.[132]

The examiner is responsible for controlling the conduct of the examination, as to each return assigned, in relation to the statute of limitations period. A return with a statute date that is set to expire within 240 days is subject to the IRS's statute control procedures[133] and Service Center Examination Statute Controls. These procedures include verification of the statute expiration date, flagging the case, completing an IRS form concerning notice of statute expiration (Form 895), notification to the group manager and the tax-exempt organization involved, securing consent to an extension of the statute when appropriate,[134] and updating the AIMS.[135]

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[130]IRM 4.75.10.7 § 1. The procedures reiterate that an examiner ''must be familiar with situations where the filing of an annual [information] return by an exempt organization, a private foundation [which is an exempt organization] or a nonexempt charitable trust can start the running of the statute of limitations for other returns and protect the statute of limitations on these returns, as necessary'' (*id*.).

[131]IRM 4.75.10.7 § 2.

[132]*Id*. § 3.

[133]IRM 25.6.23.

[134]If consent to extend the statute of limitations is requested, the examiner must advise the exempt organization of its right to refuse to extend the statute date or to request that the extension be limited to a specific period of time and/or to specific audit issues. The examiner is also required to provide the organization with a copy of the IRS publication titled *Extending the Tax Assessment Period* (Pub. 1035).

[135]IRM 4.75.10.7 § 4.

Tax-exempt organizations that are required to file an annual information return are required to file the return by the 15th day of the fifth month after the close of their fiscal year, unless the due date has been extended.[136] The general rule for the statute of limitations expiration date is that it is three years from the due date of the return or the date it was filed, whichever is later.[137] The statute of limitations expiration date is extended to six years in the following circumstances:

- If a taxpayer omits from gross income an amount properly includible in income, where the amount is in excess of 25 percent of the amount of gross income stated in the return, the income tax may be assessed, without obtaining an extension, at any time within six years after the return was filed.[138]
- If a private foundation omits from its annual information return, with respect to the tax on net investment income,[139] an amount of tax properly includible in the total amount of tax due that is in excess of 25 percent of the amount of the tax due, which is reported on the return, the tax may be assessed at any time within six years after the return was filed. If, however, a private foundation discloses in its annual information return (including an attached statement or schedule) the nature, source, and amount of any income giving rise to an omitted tax, the tax arising from that income is counted as reported on the return in computing whether the foundation has omitted more than 25 percent of the tax as reported on the return.[140]
- If a public charity or a private foundation, trust, or other organization fails to disclose an item subject to an excise tax[141] in its annual information return (or attached statement or schedule), the tax arising from any transaction not disclosed may be assessed at any time within six years after the return was filed.[142]

Examiners are cautioned to never rely on the availability of a six-year statute of limitations without the concurrence of Area Counsel.[143]

The procedures state that, as a general rule, if a return is not filed, the applicable statute of limitations period does not begin to run. The filing

[136]See App. C § VII A.
[137]IRC § 6501. Also IRM 4.75.10.7.1 § 2.
[138]IRC § 6501(e)(1); Reg. § 301.6501(e)-1(a).
[139]IRC § 4940. See App. C § V F.
[140]Reg. § 301.6501(e)-1(c)(3)(i).
[141]Namely, one or more taxes imposed by IRC §§ 4911, 4912, 4941(a), 4942(a), 4943(a), 4944(a), 4945(a), 4951(a), 4952(a), 4953, and/or 4958. Oddly, the tax imposed by IRC § 4955 is not in this list. See *supra* note 120 for a comment about the taxes imposed by IRC § 4958.
[142]IRC § 6501(e)(3); Reg. § 301.6501(e)-1(c)(2), (3)(ii).
[143]IRM 4.75.10.7.1 § 3.

of annual information returns by public charities, private foundations, and nonexempt charitable trusts, however, is somewhat of an exception to this general rule, inasmuch as the filing of an annual information return by these entities will start the running of the statute of limitations with respect to the following income and excise taxes circumstances:

- The filing of an annual information return that discloses ''sufficient facts to apprise'' the IRS of the potential existence of unrelated business income commences the running of the statute of limitations period as to assessment of income tax that should have been reported on the unrelated business income tax return (Form 990-T), even though that return was not filed.[144]
- The filing of an annual information return that discloses sufficient facts to apprise the IRS of the potential existence of tax on political expenditures may commence the running of the statute of limitations period as to assessment of tax that should have been reported on the federal income tax return filed by certain political organizations (Form 1120-POL), even though that return was not filed.
- An annual information return filed by a public charity, a private foundation, or a nonexempt charitable trust starts the running of the period of limitations as to the assessment of excise tax reported on the federal return used to report various tax-exempt organizations excise taxes (Form 4720) filed or required to be filed by the entity and on these returns filed or required to be filed by foundation managers and/or disqualified persons. The filing of the annual information return starts the running of the period of limitations on assessment of excise tax on the form even if the transaction, act, or failure to act that gives rise to the excise tax on the form is not disclosed on the annual information return. The filing of the form by an organization, foundation manager, or disqualified person does not start the running of the statute of limitations.[145]
- The filing of an annual information return by a tax-exempt charitable organization in good faith starts the running of the statute of limitations, if the organization is subsequently held to be a taxable organization.[146]

An amended return generally does not extend the statute of limitations period expiration date.[147] A ''substitute for return'' prepared by the IRS is treated, for these purposes, as if a return had not been filed; if a taxpayer signs a return substitute, the return becomes a regular return and the statute

[144]Rev. Rul. 69-247, 1969-1 C.B. 303.
[145]IRC § 6501(l)(1); Reg. § 301.6501(n)-1.
[146]IRC § 6501(g)(2); Reg. § 301.6501(g)-1(b). IRM 4.75.10.7.1 § 4.
[147]IRC § 6501(c)(7). IRM 4.75.10.7.1 § 5.

of limitations begins to run as of the date of signature.[148] An incomplete return may not start the running of a statute of limitations; the procedures provide that the following factors must exist in order for a return to be ''valid'': There must be sufficient data to calculate the tax liability, the document must purport to be a return, there must be an honest and reasonable attempt to satisfy the requirements of the tax law, and the taxpayer must execute the return under penalties of perjury.[149] The procedures state that any question an examiner may have concerning the validity of a return missing a form or schedule should be ''approached with the presumption that there is sufficient data to calculate the tax liability.''[150]

§ 5.5 EXAMINATION CYCLE

The policy of the IRS governing examinations dictates that the examination of a taxpayer must be started and closed with the appropriate examination cycle. The agency's *examination cycle* is 26 months for an individual return, 27 months for a corporate return, and 24 months for a claim.[151] The examination cycle for a return begins on the later of the date it was filed or due. The examination cycle for a claim or amended return that constitutes a claim begins with the date the claim or amended return is filed. Claims are priority work; they must be initiated within 30 days of receipt.[152]

If the examination cycle objectives cannot be met when an examination is assigned, the examiner is expected to discuss the matter with the group manager before making initial contact with the taxpayer. The group manager may decide that the examination should nonetheless be initiated. In any event, ''[m]aximum adherence to these guidelines is necessary to ensure [that] the examination and all other processing can be completed before the statute of limitations expiration date.''[153]

§ 5.6 CONFLICTS OF INTEREST

The procedures observe that it is a crime for an examiner to knowingly act as an examiner on, or to otherwise participate personally and substantially in, the examination of an organization in which he or she holds a financial interest.[154] *Financial interests* include not only interests held personally but also those of a spouse; a minor child; a general partner; an organization as to which

[148]IRM 4.75.10.7.1 § 6.
[149]*Id*. § 7.
[150]*Id*. § 8.
[151]IRM 4.75.10.8 § 1.
[152]*Id*. § 2.
[153]*Id*. §§ 3, 4.
[154]18 U.S.C. § 208.

the examiner is a trustee, director, officer, general partner, or employee; and an individual or organization with whom the examiner is negotiating for or has an arrangement concerning prospective employment.[155]

An examiner also may not act as an examiner on, or otherwise participate personally and substantially in, the examination of an organization if he or she knows that the examination is ''likely to have a direct and predictable effect on the financial interests of a member of his/her household.''[156] Similarly, an examiner should not act as an examiner on, or otherwise participate personally and substantially in, the examination of an organization if the examination involves a person with whom the examiner has a covered relationship or if a person with whom the examiner has such a relationship represents the organization in the examination.[157] A *covered relationship* exists when someone with whom the examiner has or is seeking to have a business, contractual, or financial relationship that involves something other than a ''routine consumer transaction''; a relative with whom the examiner has a ''close personal relationship'' or a member of the examiner's household; an organization for which the examiner's spouse, parent, or dependent child is, to the examiner's knowledge, working or is seeking to work; an organization for which the examiner worked in the past year; and certain organizations in which the examiner is an ''active participant.''[158] In general, an examiner is barred from examining or surveying the returns of entities with which he or she has had a business or social relationship of a nature that ''might impair their impartiality and independence.''[159]

If an examiner is assigned a return that might create a conflict of interest or an appearance of lack of impartiality, he or she is required to immediately bring the matter to the attention of the group manager.[160]

§ 5.7 PROHIBITION ON EXECUTIVE BRANCH INFLUENCE

An examiner is barred from initiating, terminating, or modifying audit actions in response to direct or indirect requests from the following Executive Branch officials: the President, the Vice-President, employees of the executive offices of the President or Vice-President, individuals serving in the President's cabinet, the U.S. trade representative, the director of the Office of Management and Budget, the Commissioner of Social Security of the Social Security Administration, and the Director of National Drug Control Policy. The U.S. Attorney

[155]IRM 4.75.10.9 § 1.
[156]*Id*. § 2.
[157]*Id*. § 3.
[158]*Id*. § 4.
[159]*Id*. § 5.
[160]*Id*. § 6.

General is excluded from this group. IRS employees may receive information from and interact with employees of other Executive Branch agencies as necessary in conducting their tax law administration responsibilities.[161]

The exceptions to this prohibition are that it does not apply to a written request (1) made by or on behalf of a taxpayer to one of the listed Executive Branch officials that is then forwarded by that office to the IRS, (2) for disclosure of returns or return information if the request is made in accordance with the federal tax law requirements,[162] and (3) made by the Secretary of the Treasury as a consequence of the implementation of a change in tax policy.[163]

The procedures state that the group manager should always be consulted if anyone other than the group manager requests action related to an ongoing or contemplated examination.[164] Also, examiners who receive a prohibited request to initiate, terminate, or modify audit actions are required to report the request to the local Treasury Inspector General for Tax Administration as soon as possible.[165]

§ 5.8 CONSECUTIVE EXAMINATIONS

Examiners are prohibited from surveying or examining a tax return if they have examined a return involving the same taxpayer for any of the three preceding tax periods, unless there has been an intervening survey or examination by another examiner.[166] Should an examiner be assigned such a return, it should be returned to the group manager for reassignment.[167] IRS policy states: ''Examiners will not examine or survey the returns of taxpayers with whom they have had a business or social relationship of a nature than might impair their impartiality and independence.''[168]

§ 5.9 REPETITIVE EXAMINATIONS

The ''repetitive examination concept'' applies when an examination of the same issue(s) in either of the two preceding years resulted in a ''no-change'' determination. An examiner should refer to the ''charge-out sheet'' that accompanies an examination file (Form 5546), which generally provides the year of the prior audit, the disposal code, the deficiency or overassessment amount, and the no-change issue codes.[169] If the sheet reflects a no-change issue code

[161]IRM 4.75.10.10 § 1.
[162]That is, pursuant to IRC § 6103.
[163]IRM 4.75.10.10 § 2.
[164]*Id*. § 3.
[165]*Id*. § 4. It is a crime for IRS employees to fail to report prohibited requests (IRC § 7217).
[166]IRM 4.75.10.11 § 1.
[167]*Id*. § 2.
[168]*Id*. § 3.
[169]IRM 4.75.10.12 § 1.

for an issue(s) under consideration in the current examination, the examiner is to eliminate the issue(s) from the audit plan, unless the case file contains information indicating otherwise.[170] Should all issues be found to be repetitive, the examiner is to obtain group manager approval to survey the return after the assignment of it.[171] If the examination has been initiated and it is determined that all issues are repetitive, resulting in little or no change to the organization's tax status or tax liability, the examiner is to obtain the group manager's approval and immediately conclude the examination.[172]

If the issues raised in a prior examination have not been resolved and if the resolution will affect the current examination, the examiner and group manager must decide whether to examine the subsequent year(s) currently or ''suspense'' the examination until the issues in the prior examination are resolved. If the subsequent years are suspensed, the procedures require that the statute of limitations period with respect to the returns involved be protected if resolution of the issues may result in a tax deficiency for the subsequent years. This includes tax deficiencies that may be due on converted returns if revocation has been proposed for the prior years.[173]

The procedures state that, if the prior examination was closed with an ''agreed change code or a no-change advisory,'' the IRS personnel should consider the possibility of recurring issues and whether the organization involved has taken any corrective action in relation to one or more matters determined in the prior examination.[174]

§ 5.10 RETURN SURVEYS

An examiner may, following assignment, survey returns or claims unless the survey is prohibited by general IRS procedural requirements or ''special project procedures.''[175] There are, however, certain approval requirements: (1) Group managers must review and approve all surveys after assignment; (2) approval of the Manager, EPP unit, is required for all surveys of returns selected for a market segment study or a compliance check project;[176] and (3) approval of the area manager is needed for the survey of returns with ''international features.''[177]

Under certain circumstances, the IRS can survey a return after taxpayer contact (assuming *taxpayer contact* does not include an inspection or ''actual review'' of a taxpayer's books of account). Circumstances when returns may be

[170] *Id*. § 2.
[171] *Id*. § 3.
[172] *Id*. § 4.
[173] *Id*. § 5.
[174] *Id*. § 6.
[175] IRM 4.75.10.13.
[176] See Chapter 4.
[177] IRM 4.75.10.13.1.

surveyed after initial contact has been made include cases involving repetitive audits, the case was assigned to an examiner who moved or left the IRS and the examiner made initial contact with the taxpayer but did not inspect the books and records, and the only contact with the taxpayer was to secure an extension of the statute of limitations period[178] and it is later determined that the return does not warrant examination.[179]

A return is to be surveyed if, after conducting the in-depth analysis and evaluating the audit potential, an examiner determines that an examination would result in no change in tax-exempt or public charity status and/or no material change in tax liability.[180] An examiner may survey claims for refund (including amended returns and informal claims) of tax-exempt organization income or excise taxes if the claim issue is clearly allowable in full and the return does not otherwise warrant examination.[181]

§ 5.11 PREEXAMINATION PROCEDURES: OVERVIEW

If—after considering the statute of limitations period, the examination cycle, the conflict-of-interest possibilities, consecutive examinations, and repetitive or prior examinations—the IRS decides to examine a tax-exempt organization's return, the following preexamination procedures are to be followed by the agency:

- The examiner is to review the return and any documents attached to it.
- The examiner is to request and analyze pertinent IDRS information, such as the filing requirements.
- The examiner is to review any applicable project guidelines or objectives.
- The following procedures should be considered:
  - Securing and reviewing the organization's determinations file
  - Requesting assistance from specialists
  - Researching identified issues[182]

The procedures observe that a good preexamination analysis ''saves time during the on-site examination by helping to organize the work, recognize and concentrate on significant issues, prepare for the initial appointment, and document the examination's course.'' It is also noted that such an analysis will ''ensure the application of quality examination standards.''[183] The preexamination analysis will further ''help identify the facts that need to be developed

[178]That is, execution of a Form 872.
[179]IRM 4.75.10.13.2.
[180]IRM 4.75.10.13.3.
[181]IRM 4.75.10.13.4.
[182]IRM 4.75.10.14 § 1.
[183]*Id.* § 2.

during the examination to resolve the identified issues.'' The procedures refer to this as the *scope of the examination*.[184]

The procedures also instruct that ''[t]ime expended on pre-examination analysis must be commensurate with actions taken.'' The explanation and need for each step should be clear. Workpapers and conclusions pertinent to the issues discovered during the preexamination analysis will become part of the case file.[185] The procedures admonish that ''there is a difference between a preplan and planning.'' It is added that planning continues throughout the examination process even though preexamination analysis has been performed and a preplan completed. The initial plan, it is noted, ''may be amended and supplemented several times during the conduct of a typical examination.''[186]

§ 5.12 REVIEW OF RETURN

The procedures sketch the process the IRS examiner is to follow when reviewing an annual information return filed by a tax-exempt organization. Not surprisingly, the first step for the examiner is to review the return for completeness, determining if all required line items and attachments are present. Schedules, statements, extensions, and attachments are to be reviewed. If information is missing, the examiner is instructed to make a note of it so as to obtain the information from the organization's representative.[187]

The procedures outline ''questions and possible issues'':

- Review the organization's ''statement of accomplishing its program services.''
- Analyze the income sources, including ''other revenue.''
- Review the yes/no questions under ''Other Information.''
- If the organization is a public charity, review the public support schedule for completeness (and, presumably, accuracy).
- If the organization is a charitable organization, review the Schedule A for the five highest paid employees and independent contractors.
- Determine if the return was filed on a timely basis and, if not, if an approved extension was obtained.[188]

The examiner is exhorted to consider any ''large, unusual and questionable items.'' What are considered *large, unusual, and questionable* items will depend on the ''perception of the return as a whole and the separate items that make

[184] *Id*. § 3.
[185] *Id*. § 5.
[186] *Id*. § 6.
[187] IRM 4.75.10.15 §§ 1, 2.
[188] *Id*. §§ 2–5.

up the return.'' These items include income, disbursements, assets, liabilities, and fund balance. The examiner is to document the reason as to why any large, unusual, or questionable items were not considered an issue.

The procedures state that large, unusual, or questionable items fall into at least four categories:

1. *Dollar amount*. The dollar amount item may be a specific amount or be ''relative, unusual, or disproportionate to the income or disbursements shown on the return.'' It might be a ''large or unusual expense for the type of organization.'' An example is provided: If the organization's total disbursements for the year were $30,000, $6,000 in legal fees may be ''significant.''
2. *Description*. The examiner is advised that it may not be possible to determine the ''validity of the item based on the way it is described on the return.'' Example: The return shows $30,000 in disbursements that are classified as ''miscellaneous.''
3. *Existence*. Some items shown on the return ''invite close scrutiny simply because they are there.'' Example: The balance sheet for liabilities lists $50,000 in loans from officers.
4. *Absence*. An item may be unusual because ''it does not appear on the return.'' The examiner should look for items that ''one would expect to find on such a return that are not there.'' Example: The balance sheet of a tax-exempt social club reflects $75,000 in cash but the return does not show any investment income.[189] Also, the examiner is to ''[c]heck the arithmetic,'' because ''[w]hat appears to be an error may actually indicate a missing item.''[190]

The examiner is to determine whether any tax liability has been accurately computed. In that connection, the examiner is to ''[l]ook for indications of activities that may affect exempt status or tax liability.'' Example: If the return reports substantial expenses for ''publications,'' the examiner is to look for advertising income.[191]

§ 5.13 REVIEW OF ACCOMPANYING IRS DOCUMENTS

The examiner is to review IRS documents that accompany the annual information return, including:

[189] *Id*. § 6. As to the fourth example, net investment income of an exempt social club is generally taxable as unrelated business income. See App. C § IX F.
[190] IRM 4.75.10.15 § 7.
[191] *Id*. §§ 8, 9. Advertising income is generally taxable as unrelated business income. See App. C § IX C.

- *Form 5546*, to determine if it shows any prior examination, no-change issue codes, and ''special messages.''
- *Classification sheets*. The examiner is to examine the identified item(s) or document the case file if the return is not to be examined.
- *Other information*. If the examination is based on a referral, the examiner is to consider what information should be obtained to address the issue(s) raised and to document the case file as to the ''viability'' of the referral. The examiner is to also to consider contacting the informant if it appears warranted.[192]

§ 5.14 DETERMINATION FILE

When an organization applies for recognition of tax-exempt status, the application, its attachments, ''related paperwork,'' and the disposition of the application are microfilmed; the IRS refers to this microfiche as the *determination file*. The examiner in the preexamination planning stage is advised to, ''if necessary,'' obtain a microfiche copy of the organization's determination file. The procedures state that doing so ''will assist in determining whether the organization is operating in the manner for which it was originally given exemption.''[193] If the determination file is not available, the examiner is instructed to ''reconstruct'' it during the examination. A reconstructed determination file should include a copy of the organization's charter, bylaws, application for recognition of exemption, and the determination letter.[194]

The examiner is instructed that the review of the determination file should cover the following: the organizational document[195] (i.e., the articles of incorporation, articles of association, constitution, charter, or trust declaration or agreement), bylaws, application for recognition of exemption, determination letter, publications, correspondence from the organization, and any technical advice memoranda.[196] The examiner is to check for any ''caveats'' and any changes in address, activities, income sources, and accounting periods.[197]

§ 5.15 RESEARCH AND ASSISTANCE

The procedures encourage the examiner to research the organization, using both internal research tools (such as IDRS)[198] and external hardcopy and

[192]IRM 4.75.10.16.
[193]IRM 4.75.10.17 § 1.
[194]*Id*. § 3.
[195]This document is referred to in the tax regulations as the *articles of organization*. See App. C § II A.
[196]IRM 4.75.10.17 §§ 4, 7.
[197]*Id*. § 5.
[198]IRM 4.75.10.18, 4.75.10.19.

electronic research tools.[199] The procedures state that ''[a]ll issues that appear likely to arise based on the review of the return and determination file should be researched to the extent necessary to develop the pre-examination plan.'' Having stated that, the procedures also observe that ''[a]lthough it is important to become familiar with identified issues[,] especially issues that have not been previously examined, it is equally important not to expend a large amount of time researching an issue that may become a non-issue once the examination is in process.''[200]

During the preexamination phase, the reviewer may determine that the assistance of a field specialist in the TE/GE Division or another operating division of the IRS will be needed. The specialist may be a computer audit specialist, an economist, an engineer, an international law specialist, an expert in the employee plans field, or a specialist in the area of tax-exempt bonds.[201]

§ 5.16 CASE CHRONOLOGY RECORD

The IRS reviewer will prepare a case chronology record (IRS Form 5464) to record actions taken in connection with the case, contacts made, follow-up dates, and time expended. Because this record becomes part of the ''audit trail,'' it ''could be disclosed to the taxpayer under the Freedom of Information Act,'' thus ''entries should be professional, accurate, and concise.'' IRS personnel are cautioned to record ''lengthy explanations'' on a separate workpaper, with reference to the workpaper in the case chronology record.[202]

The case chronology record is expected to include the following entries:

- The dates IDRS and AIMS research was requested, received, and reviewed
- The date the appointment letter, the initial information document request, and other enclosures were mailed
- The dates of appointments, including the place, time, and contact(s)
- The dates of telephone conversations with the organization's contact person(s)
- The date of receipt and processing of the power of attorney (Form 2848)
- The dates other correspondence is received from or sent to the organization's representative(s)

[199]IRM 4.75.10.21. One of the electronic research resources is the web site of the tax-exempt organization being reviewed. As the procedures observe, a web site can provide ''useful information concerning an [exempt] organization'' (IRM 4.75.10.21 § 4). See § 3.1(k).
[200]IRM 4.75.10.21 § 1.
[201]IRM 4.75.10.20.
[202]IRM 4.75.10.22 § 1.

- The date the consent to extend the running of the statute of limitations period (Form 872) was issued and was obtained
- The date(s) of issuance of subsequent information document request(s) and follow-up date(s)
- The date(s) research is undertaken
- Delays or lack of cooperation by the organization and/or its representative(s)
- Explanation for delay of ''significant action'' on the case by the examiner
- The date the case was closed[203]

§ 5.17 WORKPAPER SUMMARY

The reviewer is required to prepare an EO workpaper summary (Form 5772[204]), which is used for preexamination planning. This summary contains a list of ''procedural and technical reminders.'' During the preexamination, the reviewer should complete the following items on the summary: the organization's name, address, and tax identification number; return form number; year(s) under examination; the name of the specialist; and the items to be considered. Additional items may be added during the on-site examination and case closing.[205] A separate form (Form 5773, the workpaper summary continuation sheet) is used to index the workpapers; to document the analysis of books, records, and materials relating to the issues identified for examination; and to summarize the audit steps, findings, and conclusions of the examination.[206]

§ 5.18 COMMENCEMENT OF EXAMINATION

This is the point in the IRS process of examining tax-exempt organizations where the exempt organization and its representatives become aware of the agency's scrutiny of the organization. The practitioner involved should then begin to understand all that has gone before within the IRS. Needless to say, this phase of the proceedings begins with the initial taxpayer contact.

(a) Initial Taxpayer Contact

(i) Definition. The procedures define the term *initial contact* as the ''first contact with the taxpayer after the pre-examination analysis and before the

[203]*Id*. § 5.
[204]If the organization being reviewed is a private foundation, the EO workpaper summary is Form 5774 (IRM 4.75.10.22.3).
[205]IRM 4.75.10.22.2.
[206]IRM 4.75.10.22.4.

initial interview.'' Generally, the initial contact is for the purpose of arranging the initial interview. The organization may be contacted by telephone or in writing to schedule the initial appointment; from the standpoint of the IRS, initial contact by telephone is the IRS's preferred approach (and will usually be the case). The examiner is required to complete a detailed preexamination analysis of the information available from internal sources and the returns before the initial contact.[207]

The IRS has the authority to set the time and place of the examination under reasonable circumstances.[208] Field examinations are normally conducted at the organization's place of business and/or where the books and records are maintained.[209] In this context, the goal of the initial contact is to set the examination, ''maximize convenience for the taxpayer,'' and ''efficiently administer'' the tax laws.[210]

(ii) Contact Person. Before the examiner contacts the organization to discuss the examination, he or she should determine the ''appropriate individual to contact.'' The individual contacted should have the authority to receive ''confidential tax information'' concerning the organization; these individuals are:

- An officer of the organization who has the authority under applicable state law to legally bind the entity
- A fiduciary, such as a trustee
- An individual, usually a director, officer, or employee of the organization, who is specifically authorized to bind the entity in accordance with the entity's organizing documents, a resolution of the governing board, or other legally binding document
- An individual who has a valid power of attorney or tax information authorization on file with the IRS for the type of return and year(s) included in the examination

To avoid making an unauthorized disclosure,[211] the examiner must verify the identity of the individual contacted and determine whether he or she has an ''ongoing relationship'' with the organization entitling him or her to receive confidential tax information before discussing the examination. In the case of a corporation, if the corporate officer contacted is not an officer designated by state law to bind the corporation, the examiner must, before discussing the examination, ask the officer if he or she can legally bind the corporation. If the

[207]IRM 4.75.10.23 §§ 1, 3.
[208]IRC § 7605(a).
[209]See § 1.6(a).
[210]IRM 4.75.10.23 § 2.
[211]IRC § 7213 imposes sanctions for such disclosures.

examiner determines that the individual contacted does not have the proper authority to receive confidential tax information, the examiner should limit the conversation to determining the name and telephone number of an individual who does have the requisite authority.[212] The questions asked and responses received must be documented in the workpapers.[213]

(iii) Initial Contact. When the examiner makes the initial contact with a tax-exempt organization by telephone, he or she is to ''immediately'' state the purpose of the call (which is, of course, to commence the examination) and identify himself or herself by name, employee identification number, and telephone number.[214]

During this ''conversation,'' the examiner is required to do the following:

- Briefly explain the examination process.
- Identify the return(s) being examined and the tax period(s) involved.
- Inquire as to whether the organization will be represented by one or more individuals who will be identified in a power of attorney and, if so, request that form (Form 2848).[215]
- Ask whether the organization has been examined in prior years.
- Discuss the issues identified by the IRS during the preexamination process.[216]
- Explain that additional issues may be examined, depending on the information obtained in the course of the examination.
- Determine the type and location of the organization's books and records.
- Establish the location where the examination will take place.
- Ask for ''clear directions to the audit site.''
- Schedule the initial appointment (if appropriate at this stage[217]).[218]

[212]If there is a question as to whether an individual contacted has the requisite authority, the examiner may obtain a written statement by the individual, on the organization's letterhead, stating that he or she has the authority to legally bind the organization so as to permit disclosure.
[213]IRM 4.75.10.23 § 4.
[214]IRM 4.75.10.23.1 § 1.
[215]Where an exempt organization is to be represented by one or more individuals pursuant to a power of attorney, the examiner is cautioned to ''take care [to] not begin the examination through questioning during the initial contact since this may give the impression of attempting to bypass the representative.'' The examiner is authorized to allow at least 10 business days for the organization to secure representation before scheduling the initial appointment; extensions of this period may be granted. IRM 4.75.10.23.1 § 2 C.
[216]If, however, the examination has been initiated because of an informant, the examiner may be precluded from discussing the issues with the organization at this stage. IRM 4.75.10.23.1 § 2E.
[217]See text accompanied by *supra* note 211.
[218]This item is not on the list in the procedures but is inherent in the process.

- Explain that a letter confirming the scheduled appointment, accompanied by a ''detailed'' information document request, will be mailed.
- Ask the individual contacted if there are any questions.[219]

If the examiner is unable to contact a tax-exempt organization by telephone, he or she is required to send the organization an appointment letter. An initial information document request will be sent with this letter; this IDR must ask the organization to confirm the availability and format of the books and records, and identify the preplanned issues. If a response is received and a telephone number is provided, the examiner will call the organization to determine the availability of the records requested and discuss the preplanned issues. If there is no response to the appointment letter, a copy of it and of the initial IDR will be sent by the IRS by certified mail.[220]

The examiner is to make an effort to schedule the initial appointment and any follow-up appointments at a time that is agreeable to the representative(s) of the tax-exempt organization. These appointments are to be scheduled during normal business hours, although it is customary for the IRS to accommodate organizations in cases of religious and secular holidays. The examiner has the authority to grant up to an additional 45 days in response to a request on behalf of an exempt organization to postpone the initial appointment date suggested by him or her. In the face of exempt organization efforts to further postpone the appointment, the examiner is to discuss the situation with the group manager.[221]

Usually, the initial appointment is scheduled with the tax-exempt organization. An employee, officer, or the like of an exempt organization is not required to be present at the initial interview.[222] The interview can be conducted with anyone who is authorized by the organization, as long as that individual has ''firsthand knowledge of the information requested and [is in a position to] confirm that the information obtained can be relied upon.''[223]

(iv) Examination Transfers. When setting the initial appointment, the examiner may receive from a tax-exempt organization a request for a transfer of the examination to another location. The IRS has the authority to reasonably set the time and place of an examination.[224] An examination is usually conducted in the area where the organization is physically located, has its principal office,

[219]IRM 4.75.10.23.1 §§ 2, 3.
[220]IRM 4.75.10.23.2. The procedures outline the steps to be taken by an examiner to locate the ''whereabouts'' of a tax-exempt organization that is not responsive to the IRS's initial contact efforts (IRM 4.75.10.26).
[221]IRM 4.75.10.27 §§ 1, 2.
[222]IRC § 7521(c).
[223]IRM 4.75.10.27 § 3.
[224]IRC § 7602; Reg. § 301.7605-1(c)(2).

carries out business transactions, and maintains its books and records.[225] Generally, the IRS will grant a request for examination transfer where the organization's address is no longer where an examination has been scheduled or the organization's books, records, and source documents are maintained at a location other than where the examination has been scheduled.[226]

An examiner is to evaluate a transfer request on a case-by-case basis, taking into consideration factors such as the organization's current address; the location of the organization's business; the location of the organization's books and records, including vouchers, invoices, canceled checks, and other documents usually maintained at the business site; the location where the IRS can perform the examination most efficiently; the availability of the IRS's resources at the location where the examination would be transferred; and other circumstances indicating that conduct of the examination at a particular location would create ''undue inconvenience'' for the organization.[227] Generally, the IRS will not transfer the location of an examination for the convenience of the organization's representative nor will the representative's place of business determine the examination's location.[228] Nonetheless, the IRS may consider the request by an exempt organization or its representative to transfer the place of the examination to the representative's office ''after weighing all factors.''[229]

A request to transfer the place of an examination must be in writing and include the following information:

- The reason why the requested location is more efficient for the examination
- The organization's current address, telephone number, and current principal place of business
- The location of the organization's books, records, and source documents
- Information as to who possesses the required records and will be available to expediently resolve issues
- Available resources in the area to which the organization requests transfer (if known)
- Other factors that show how conduct of the examination at a particular location poses undue inconvenience for the organization[230]

The examiner may initiate a transfer of an examination if it promotes ''effective and efficient'' conduct of the inquiry. If the tax-exempt organization

[225]IRM 4.75.10.28 § 1. See § 1.6(a).
[226]IRM 4.75.10.28 § 2.
[227]*Id*. § 3.
[228]Reg. § 301.7605-1(e)(3).
[229]IRM 4.75.10.28.1.
[230]IRM 4.75.10.28.2; Reg. § 301.7605-1(e).

requests that a transfer not be made, the examiner is to consider the request according to the required factors.[231]

Notwithstanding the foregoing, a minimum of 13 months must remain in the statute of limitations period at the time of the transfer request in order for an examination to be transferred, although the tax-exempt organization can fulfill this requirement by agreeing to a one-year extension of the statute.[232] A transfer request will not be granted, however, if a statutory notice of deficiency (90-day letter) has been issued.[233]

If the examiner decides to honor the examination transfer request, the group manager is to be contacted so that he or she can call the receiving group manager in an instance of an intra-area transfer or the area manager in the case of an out-of-the-area transfer to discuss the transfer.[234]

(v) Initial Information Document Request. As noted, an examiner must prepare an information document request (Form 4564) (IDR) to send with the initial appointment letter.[235] This IDR ''should address items pertinent to the particular case.'' The IDR is to be tailored to the type of tax-exempt organization and to the issues that have been identified in the preexamination analysis. The examiner is admonished to ''not ask for more information than is essential to resolve the issues.'' Also, the procedures note that the ''more detailed the information requested, the more likely it is [that] the taxpayer will have the correct information available at the first appointment,'' thereby likely reducing the necessity of follow-up appointments.[236]

When preparing the initial IDR, the examiner is to keep in mind that ''no more than what is specifically requested will be obtained.'' (This is likely to be the outcome because counsel for the tax-exempt organization advised it to produce only the documents and other information precisely identified and requested in the IDR.) In general, the IDR should contain a list of items that have already been discussed with the officer or director of the exempt organization in the course of the initial telephone discussion.[237]

Some documents concerning the tax-exempt organization under examination may be in the possession of the IRS and accessible to the examiner. During the preexamination phase, the examiner will have had access to the IDRS and the AIMS. Thus, the examiner will (or should) know the organization's exempt status, filing status, statute of limitation dates relating to returns, penalties

[231]IRM 4.75.10.28.3.
[232]IRM 4.75.10.28.4 § 2; Reg. § 301.7605-1(e)(4).
[233]IRM 4.75.10.28.4 § 3.
[234]IRM 4.75.10.28.5 § 1.
[235]See § 1.4.
[236]IRM 4.75.10.29 §§ 1, 2.
[237]*Id*. § 3.

(if any) assessed, and amounts of any tax paid, and have access to certain forms and returns (such as power(s) of attorney and employment tax returns).[238]

The initial IDR must identify the books, records, papers, or other data being requested of the tax-exempt organization with the particular activity and time period to which they relate. If the list of requested records includes copies, the examiner should specify whether the copies are being requested for review during the on-site examination or the organization is being asked to make copies that the examiner may retain. (If the exempt organization wants to be, or appear to be, cooperative in connection with the audit, it will voluntarily select the second of these options.) It is ''advisable'' for the examiner to include a statement on the initial IDR indicating that additional records probably will be requested as the examination progresses. The IDR should always include a date for submission of the requested documents or other information; in the case of an initial IDR, that date generally will be the date of the initial appointment.[239]

The procedures advise the examiner to consider requesting from the tax-exempt organization the following types of accountants' workpapers or reports:

- *Tax reconciliation workpapers*. Tax reconciliation workpapers are used in compiling financial data in connection with preparation of an information or tax return. Typically, these workpapers will include a ''final trial balance and/or a schedule of adjusting entries.'' They include information used to ''trace financial information to the return.''
- *Audit workpapers*. Audit workpapers consist of documentation retained by an independent accountant as to the procedures followed, tests performed, information obtained, and conclusions that he or she reached. They support the accountant's opinion as to the fairness of the presentation of the financial statements, and conformity and compliance with generally accepted accounting principles.
- *Representation letter*. A certified public accountant/auditor is required to obtain client management's written representations for all financial statements and periods covered by the auditor's report. These statements include information concerning fraud, material errors, and the belief that the financial statements are fairly presented in conformity with generally accepted accounting principles.[240]

The procedures instruct the examiner to request tax reconciliation workpapers, unlike audit workpapers, at the beginning of an examination. These

[238]IRM 4.75.10-3.
[239]IRM 4.75.10.29.1.
[240]IRM 4.75.10.30 § 1. The representation letter, however, may be a privileged communication (IRC § 7525).

workpapers will be needed at the outset inasmuch as they ''include the final amounts that should tie the filed return to the general ledger.''[241]

The properly prepared initial IDR will identify the return(s) and the year(s) under examination (first paragraph), state the date the records are to be available (second paragraph), and contain a clear statement of the specific periods for which the records are being requested.[242] This IDR should be tailored to the tax-exempt organization under examination on the basis of the preexamination analysis and the initial contact. Only records necessary to examine the preplanned issues should be requested; certain documents that might be requested in other examinations (such as pension plan documents and unrelated business income tax returns) will not be requested because the examiner determined during the course of the preexamination analysis and initial contact that they do not exist. The initial IDR will notify the exempt organization that additional records may be needed (last paragraph).[243]

(vi) Planning Initial Interview. IRS examiners have the authority to take testimony as may be relevant to ascertain the correctness of any return, make a return where none has been made, and determine the liability for any internal revenue tax.[244]

As part of the preexamination planning, the examiner is expected to formulate questions to be asked in the initial interview. The primary reason for the initial interview is to ''help confirm the reliability of the [tax-exempt organization's] books and records.'' This interview ''also provides knowledge about the organization's history, its activities, the type and source of income generated, the extent of its internal control, and types of books and records maintained.''[245]

The procedures observe that planning and organizing questions to ask in the initial interview are as important as preparing the initial IDR. Proper preparation in this regard ''will give the examiner freedom to listen more carefully and proceed efficiently with the examination.''[246]

The examiner is to base the initial interview questions on ''observations during the pre-examination analysis and issues that will be developed.'' He or she is advised to write the questions or outline them, leaving sufficient space on the list of questions or outline to jot down notes during the interview. The examiner is reminded that this approach does not inhibit his or her ability to

[241]IRM 4.75.10.30 § 2.
[242]See § 1.4.
[243]IRM 4.75.10-4. The procedures include a prototype of an examiner's summary of his or her preexamination analysis and of what transpired during the initial contact (*id*.).
[244]IRC § 7602; IRM 4.75.10.31 § 1. See § 1.1, text accompanied by note 9.
[245]IRM 4.75.10.31 § 2.
[246]*Id*. § 3.

ask additional questions; the examiner is to be ready to ask for clarification or to follow up on questions.[247]

The representative of a tax-exempt organization, participating in an initial interview with an IRS examiner, can anticipate questions such as the following:

- Will any of the representatives be executing a power of attorney?
- Did the organization receive IRS Publication 1?[248]
- What were the results of any prior IRS or state audits?
- What is the organization's history?
- Who are the organization's members?
- What are the exempt purposes of the organization?
- What are the activities of the organization?
- Does the organization distribute publications?
- What individuals does the organization treat as employees?
- Who are the members of the organization's board of directors?
- How often are board meetings held?
- What are the principal sources of the organization's revenue?
- Who can/must sign disbursement checks?
- Who prepares the organization's returns?
- What types of books and records are maintained?
- Who records transactions?
- Are there loans to or from officers and/or employees?
- Are loans recorded?
- What are the organization's assets?
- Where are the assets located?
- How are the assets utilized?
- What are the organization's liabilities?
- What federal tax forms does the organization understand it is required to file?[249]

The foregoing questions are listed in the procedures. Other questions that may be asked are:

[247]IRM 4.75.10.31.1 § 1.
[248]See, e.g., § 1.5.
[249]IRM 4.75.10.31.1 § 2.

- Does the organization have a web site?
- Who has the authority to post material on the site?
- Who are the organization's officers?

Nonetheless, while ''pro forma interviews can be utilized,'' they should be ''customized to fit the taxpayer under examination and open to follow-up questions.''[250]

(b) On-Site Examinations

The procedures provide guidelines and techniques to assist IRS examiners in achieving ''more uniformity and efficiency'' in the conduct of examinations of tax-exempt organizations. At the same time, an understanding of the examination procedures enables the exempt organization and its representatives to formulate a strategy for participating in the process in the best interests of the organization. Notwithstanding the procedures, however, the ''professional judgment'' of the examiner will be a major factor in establishing the ''appropriate scope and depth'' of the examination.[251]

(i) Quality Examinations. From the standpoint of the IRS, a *quality examination* is one ''in which the examiner reaches the appropriate technical conclusions for all significant issues, while providing professional customer service'' to the tax-exempt organization.[252] The IRS has established—as an aspect of the TEQMS—eight *quality standards* for examination of exempt organizations cases:

1. Examination planning
2. Examination scope
3. Documents/operational compliance
4. Examination techniques
5. Workpapers/reports
6. Application of law/tax determination
7. Timeliness
8. Customer relations/professionalism[253]

[250] *Id.*
[251] IRM 4.75.11.1. See Chapter 7 for the IRS guidelines that are to assist an examiner in auditing a particular type of tax-exempt organization.
[252] IRM 4.75.11.2 § 1.
[253] IRM 4.75.11.2 § 2.

(ii) Examination Objectives. The primary objectives of an examination of a tax-exempt organization, from the perspective of the IRS,[254] are to determine whether the organization is organized and operated in accordance with its exempt function,[255] and to provide quality customer service to the exempt organization.[256] In addition to a review of an exempt organization's activities, an examiner should determine whether the exempt organization:

- Is liable for the unrelated business income tax, has computed the correct amount of that tax, and has properly reported it to the IRS (by filing Form 990-T)[257]
- Is liable for the correct amount of IRC Chapter 42 taxes[258]
- Has engaged in political activities that require a reporting to the IRS (by filing Form 1120-POL)[259]
- Has properly filed all applicable returns and forms for which it is liable (e.g., Forms 940, 941, 945, 1096, 1099, W-2, W-3, 11-C, and 730)
- Has timely filed a complete and accurate annual information return (generally, Form 990, 990-EZ, or 990-PF)[260]

In general, the examiner has the responsibility, to the tax-exempt organization and the government, to determine qualification for exemption, and to maintain a fair and impartial attitude in all matters relating to the examination.[261]

(iii) Customer Service. The procedures state that the IRS has ''pledged to provide prompt, professional, helpful treatment to taxpayers.''[262] This translates to *quality customer service* by the IRS, which means ''adopting business practices that ensure [that the] tax laws are applied fairly while observing the rights of taxpayers and making compliance easier.''[263]

The ''efficient examination of returns conducted in a fair and impartial manner is an important means'' of accomplishing the IRS's objectives in this

[254]The primary objectives of such an examination from the perspective of the tax-exempt organization are to have a successful outcome (no-change report and/or no assessment of taxes and/or penalties), and to have the examination end as quickly as possible (and at the least financial cost).
[255]If the organization under examination is a charitable one (an IRC § 501(c)(3) entity), an IRS objective will include proper determination of its public charity/private foundation status. See App. C § V.
[256]IRM 4.75.11.3 § 1.
[257]See App. C § VII C.
[258]See *id*. § V F.
[259]See *id*. § VII B.
[260]IRM 4.75.11.3 § 2. See App. C § VII A.
[261]IRM 4.75.11.3 § 3.
[262]IRM 4.75.11.3.1 § 1.
[263]*Id*. § 2.

regard, the procedures state, and thus examiners are responsible for conducting examinations in a manner that:

- Promotes the efficient utilization of time
- Addresses all of the taxpayer's concerns
- Informs the taxpayer of all rights
- Protects the taxpayer's privacy and confidentiality[264]

The examiner and/or manager is required to ''adequately document'' all communications with the tax-exempt organization under examination, such as telephone calls and correspondence.[265]

The examiner's correspondence and other interactions with tax-exempt organizations are to be ''courteous and professional,'' with ''inflammatory comments and assumptions'' avoided. The examiner should address an exempt organization's questions regarding account status or refer the matter to the appropriate party. All cases are to be worked ''timely and efficiently,'' with the audit objectives accomplished in a manner that is ''least intrusive and burdensome'' on the organization. The examiner should adhere to the established time frames for completing actions on cases. Any delays in processing a case should be discussed with the exempt organization; it is to be apprised of the status of the case throughout the examination.[266]

(iv) National Standard Time Frames. The IRS has developed *national standard time frames* that set forth the maximum allowable time, from the standpoint of the IRS, to complete certain actions:

- Number of days for the examiner to close an agreed or no-change examination, beginning with the first date that the signed report is received from the tax-exempt organization or from the date the no-change determination is made by the examiner
- Twenty days for the examiner to close unagreed determinations, from the final closing conference or after the closing conference was declined
- Forty-five days between ''significant activities'' (such as awaiting a response to an IDR from an exempt organization)
- Ten days for the manager to initial/date the case file after receipt from the examiner
- Three days to respond to telephone calls
- Fourteen days to respond to correspondence[267]

[264]*Id*. § 3.
[265]*Id*. § 4.
[266]IRM 4.75.11.3.1.1.
[267]IRM 4.75.11.3.1.2. For this purpose, all days are calendar days, except for responses to telephone calls, the response period for which is based on business days.

The examiner is required to explain the tax-exempt organization's rights[268] at the beginning of the examination. Also, at the conclusion of the examination, when adjustments have been recommended, the examiner must advise the organization and its representatives of all appeal rights. The examiner is responsible for protecting the organization's privacy and safeguarding confidential taxpayer information; he or she must ensure that audit issues are discussed only with authorized individuals.

(v) Initial Examination Scope. The appropriate scope of the initial examination is the general responsibility of the examiner; the scope is to be established so that the objectives of the audit are met in a manner that is ''least intrusive and burdensome'' to the organization. He or she must ensure that ''all significant items'' affecting the organization's tax-exempt status and/or tax liability are adequately considered. Also, once the examination is under way, the examiner and group manager should continuously consider the appropriate scope of the examination and make adjustments as necessary.[269]

The scope of an IRS examination of a tax-exempt organization is dependent on a variety of factors, including the size of the organization, the complexity of the return, the source of the examination (such as whether it is a referral or a special project), and ''managerial direction.'' The examination scope is to be set during the preexamination phase and may be expanded or contracted during the course of the examination on the basis of the condition of the organization's books and records, the adequacy of internal controls, changes in the organization's operations, and additional issues that become evident during the flow of the examination. In establishing this scope, the examiner is to consider only ''material or significant'' items. Items can be *material* in absolute dollar value or the relative dollar value based on a multiyear comparison or industry standard. The examiner should ''properly consider'' all filing and compliance items. Also, the examiner and group manager should consider whether, to reduce a tax-exempt organization's burden and travel costs, an examination can be worked pursuant to the OCEP system.[270]

In all examinations, the examiner is required to review the tax-exempt organization's organizing documents to determine the entity's exempt purpose and compliance with the organizational test.[271] The examiner also must, unless the examination is of limited scope,[272] perform an in-depth review of the operations of the organization to ensure that it continues to meet the requirements for exemption (i.e., satisfy the operational test[273]). The examiner

[268]See § 1.5.
[269]IRM 4.75.11.4 §§ 1–3.
[270]IRM 4.75.11.4 §§ 4–8.
[271]See App. C § II A.
[272]See § 5.18(c).
[273]See App. C § II B.

is required to identify and verify the programs and other activities (such as by means of utilization of staff and other resources, and expenditures) by which an organization furthers its exempt purposes. The examiner is expected to identify ''unusual transactions,'' seek out the purpose of these transactions, and determine whether they are related or unrelated to the organization's exempt purposes.[274]

(c) Limited Scope Examinations

In certain cases, the scope of an examination may be limited to specific issues, as identified by the EPP function.[275] This is known as a *limited scope examination*. A manager may direct an examiner to limit the scope of an examination; when this occurs, however, the manager must explain which issues are not being pursued and why.[276]

Limited scope examinations generally include only classified issues and large, unusual, and questionable items reflected on the return or discovered during the examination. Nonetheless, there is an ''expectation'' that examinations will be expanded when the facts warrant. An examiner cannot pursue additional issues in a limited scope examination without the manager's approval.[277]

In all limited scope examinations, the examiner is required to review the organizing documents to determine the organization's tax-exempt purpose. Where the exempt purpose is not a classified issue, an analysis of the organization's operations is ''not generally appropriate.'' If, however, during the course of the examination, one or more operational issues become apparent, the scope of the examination may be expanded. Also, in every case, the examiner must establish that the organization filed all required federal returns.[278]

(d) Evaluation of Internal Controls

Examiners are required to evaluate the existence and effectiveness of the internal controls of a tax-exempt organization and expand or contract the scope of the examination appropriately.[279] For this purpose, the term *internal controls* means the organization's ''policies and procedures to identify, measure and safeguard business operations and avoid material misstatements of financial information.'' The lack of ''good'' internal controls may be an indication of the potential for diverted receipts, diverted assets, or similar problems. The lack

[274]IRM 4.75.11.4.1.
[275]See, e.g., § 5.2(b).
[276]IRM 4.75.11.4.2 §§ 1, 2.
[277]*Id*. § 3.
[278]*Id*. § 4, 5.
[279]IRM 4.75.11.4.3.1 § 1.

of internal controls does not ''necessarily'' jeopardize exempt status but it may affect the scope of the examination.[280]

In determining whether reliance on the tax-exempt organization's books and records is appropriate, the examiner is to consider the extent to which the following ''control checks'' are utilized by the organization:

- Transactions are recorded in the books and records in a timely manner.
- The return reconciles to the books.
- The organization reconciles its bank statement balances to the books.
- There is ''segregation of duties.''
- The organization has an active board of directors overseeing its operations.
- There are outside third parties, such as a governmental agency, overseeing the organization.
- The organization has an annual independent audit.[281]

In a case where an organization's internal controls are found to be inadequate, the examiner is to consider using ''indirect examination techniques'' to meet the examination objectives, which may include:

- *Oral testimony*. Oral testimony is particularly useful in situations where the organization's records have been lost or destroyed, such as in a fire or flood. In these cases, statements made on behalf of the organization may be the only evidence available. If, however, the examiner has reason to doubt the reliability of the oral testimony presented, he or she should attempt to obtain other corroborating evidence.
- *Third-party records.*[282]
- *Subsequent year examination*. A subsequent year examination may be of assistance, such as where the election of new officers has resulted in an improvement in the maintenance of records.[283]

If a tax-exempt organization has failed to substantially comply with the law requiring maintenance of adequate books and records,[284] or with record retention limitation agreements, the examiner should discuss the inadequacies with his or her group manager to determine whether an *inadequate records notice* should be recommended. If the determination involves a record retention limitation agreement, the computer audit specialist manager must be

[280]IRM 4.75.11.4.3.
[281]IRM 4.75.11.4.3.1 § 2.
[282]See § 1.8.
[283]IRM 4.75.11.4.3.1 §§ 3, 4.
[284]See App. C § XII D.

contacted. The determination as to whether an exempt organization has maintained adequate records or has complied with a record retention limitation agreement is a matter of judgment based on the facts and circumstances of the particular case; factors to be considered in either case include the prior history and present degree of noncompliance, indications of willful intent, evidence of refusal to keep records, other evidence of harm to the government, and the probability that poor recordkeeping will result in significant changes to the return.[285]

(e) Examiner Workpapers

The examiner's report concerning a tax-exempt organization will be principally supported by his or her workpapers, which should document the procedures applied, audit tests performed, information inspected, research conducted, and the conclusions reached during the examination.[286] (Examiner workpapers are available by application of the Freedom of Information Act.[287]) These workpapers must provide adequate documentation, in support of the conclusion that the organization either continues to qualify for exemption or no longer qualifies.[288]

Quality workpapers are expected to have the following characteristics:

- *Accurate*. The final conclusion must be accurate and based on the law.
- *Legible*. The workpapers should be prepared on the computer ''whenever practical''; if handwritten, they must be readable.
- *Clear*. The workpapers should clearly describe all of the steps taken in reaching a conclusion.
- *Concise*. Only relevant facts should be included, stated simply and plainly. The workpapers should contain only those schedules that are pertinent.
- *Organized and properly labeled*. The workpapers should be organized and appropriately indexed; they should be properly labeled, dated, and initialed.
- *Professional*. The workpapers should not contain any derogatory remarks about the exempt organization and/or its representative(s).[289]

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[285]IRM 4.75.11.4.3.2.

[286]IRM 4.75.11.5.3 § 1. The IRS forms involved are the EO Workpaper Summary (Form 5772), the EO Workpaper Summary Continuation Sheet (Form 5773), and the Private Foundation Workpapers (Form 5774). IRM 4.75.11.5.2, 4.75.11.5.2.2, 4.75.11.5.2.3, 4.75.11.5.2.4. The format for examiners' workpapers is the subject of IRM 4.75.11.5.4.

[287]See § 4.11.

[288]IRM 4.75.11.5 §§ 1, 2.

[289]*Id*. § 3.

An examiner's supporting workpapers generally consist of documentation of audit techniques (such as interviews, review of minutes, and analysis of financial statements); summary of information provided by means of interviews, minutes, and the like, which is used to draw conclusions about tax-exempt status, tax liability, or other identified issues raised by the examiner; and copies of an organization's records used in the analysis. The examiner should use judgment in determining the content of the workpapers, in that every workpaper in the file should have some relevance to accomplishing the objectives of the examination.[290]

In preparing the workpapers, the examiner should prepare a workpaper describing the organization's activities conducted during the year(s) under examination; explaining how these activities furthered the organization's exempt purpose (if they did); and adequately documenting all tests performed, in the case of a charitable organization, to determine the correct public charity/private foundation status.[291] Examiners are expected to exercise good judgment in securing copies of documents for the file, including them only if they are ''materially utilized and add value.''[292] When there are multiple returns involved in an examination (such as a Form 990 and 990-T), the examiner should prepare a set of workpapers for each return.[293]

Examiner workpapers serve multiple purposes, such as assisting reviewers, managers, or others in determining the sufficiency of the examination; providing a source of information for use in connection with subsequent examinations; and becoming a part of the administrative record in the event the case is litigated.[294]

(f) Examination Techniques

The procedures observe that there are ''various methods to obtain the information necessary to meet the objectives of an exempt organization examination,'' with some ''common examination techniques'' being interview(s), tour of facilities, and review of the organization's books and records, including governing instruments, minutes, publications, and financial records.[295]

Discussions and interviews with the officials of a tax-exempt organization are a ''very important part'' of the examination, the procedures state, offering these pointers to examiners:

- An interview should be conducted at or near the beginning of every examination.

[290]IRM 4.75.11.5.3 §§ 2, 3.
[291]IRM 4.75.11.5.3.1.
[292]IRM 4.75.11.5.3.2.
[293]IRM 4.75.11.5.4.5.
[294]*Id*. § 4.
[295]IRM 4.75.11.6 § 1.

- Additional interviews should be conducted throughout the examination, as necessary to clarify questionable items and/or follow up on potential issues that are identified during the examination.
- Interviews should be conducted with one or more individuals having sufficient knowledge of the exempt organization's operations.
- Questions that will provide an overall view of the organization's activities should be asked.
- Interviews should be used to obtain information needed to make informed judgments about the scope and depth of the examination, and correctly resolve issues.
- Interviews are also used to obtain leads, develop information, and establish evidence.
- Interviews should be properly documented in sufficient depth to give a clear understanding of the organization's activities.[296]

An examiner cannot require an official of a tax-exempt organization to accompany an authorized representative to an examination interview in the absence of an administrative summons.[297] The examiner can, of course, request an individual's voluntary presence at an interview as a means to ''expedite the examination process.''[298]

The procedures also provide examiners with some ''important points'' in ''effective questioning techniques'':

- The interview should be planned, so as to address the items that are specific to the tax-exempt organization being examined.
- The examiner should research questionable items on the return so as to know what questions to ask.
- The questions should be ''clear, relevant, and objective.''
- The examiner should be ''direct,'' while ''maintaining a courteous, professional image.''
- The examiner should listen to the responses and ask further questions about any responses that are ''inconsistent, vague or did not adequately answer the question.''
- The examiner is to use ''open-ended'' questions, forcing the interviewee to answer ''using full sentences'' rather than mere ''yes'' or ''no'' responses.[299]

[296]IRM 4.75.11.6.1 §§ 1–7.
[297]IRC § 7521(c).
[298]IRM 4.75.11.6.1 § 8.
[299]IRM 4.75.11.6.1 § 9.

Representatives of tax-exempt organizations can request audio recordings of interviews.[300] The examiner is to immediately refer a request to make a tape, stenographic, or other verbatim recording to the group manager for approval. If granted, the manager will arrange an appropriate time and suitable location in an IRS office where equipment is available to make the ''Service's recording.'' If an official of an exempt organization, a legal representative of it, or a witness appears in an examination proceeding and requests the making of a verbatim recording without the IRS's prior knowledge, the examiner and the group manager will attempt to make arrangements for space and recording equipment in an effort to continue the proceeding. If the requisite space and/or equipment is not immediately available, the appointment will be rescheduled. The IRS can initiate a recording of an interview; the agency is required to notify the exempt organization of this intent to record at least 10 calendar days in advance of the interview. The IRS will not grant requests to videotape or otherwise film examination proceedings.[301]

All recorded interviews must contain the following information:

- The date, time, and place of the interview
- The tax-exempt organization's name and tax identification number
- The name and Social Security number of the individual who is to be interviewed
- Identification of all participants in the interview, along with a statement of each participant's role in the proceeding
- Notation of the arrival or departure of a participant
- The purpose of the proceeding
- The tax year(s) under examination
- A clear description of documentation provided in support of the issues
- A concluding statement, indicating the length of time of the recorded interview, the fact that the interview has been completed, and the fact that the recording has ended

A recording produced by the IRS is to be immediately reviewed for clarity and substance. If necessary, a complete written report of the interview should immediately be prepared ''as an explanation of the information on the tape.''[302]

(g) Initial Interview

During the initial interview, the examiner must confirm that the tax-exempt organization has his or her correct name, telephone number, and badge

[300]IRC § 7521.
[301]IRM 4.75.11.6.1.1 §§ 1–3.
[302]*Id*. §§ 4–5.

number; show his or her badge or credentials to the organization;[303] explain the examination process, the purpose of the examination, and the organization's appeal rights; confirm that the exempt organization has received a copy of IRS Publication 1;[304] and ascertain whether a representative of the organization has any questions.[305]

The following items should be discussed by the examiner with the tax-exempt organization:

- The availability of requested books and records (if this was not already determined during the preexamination phase[306])
- An explanation of the organization's accounting system
- A description of the organization's ''activities and current operations''
- The issues identified during the preexamination planning process[307]

The examiner must suspend the interview if an official of the tax-exempt organization states that he or she desires to consult with a qualified representative.[308] This rule, however, does not apply in the case of an interview that has been initiated pursuant to an administrative summons. Also, the rule cannot be used to ''repeatedly delay or hinder'' the examination process.[309]

(h) Third-Party Contacts

Generally, an examiner, in conjunction with an examination of a tax-exempt organization, will contact a third party only when the examiner is unable to obtain information from a representative of the organization or to verify information provided on behalf of an organization. Examiners are required to ''make every effort to first obtain information'' from the organization or a representative of it.[310] It is the policy of the IRS to ''obtain information relating to a liability or collectibles determination directly from the taxpayer whenever possible.''[311]

In connection with third-party contacts made for the purpose of determining or collecting a tax liability, the IRS is required to provide advance notice to the taxpayer that third-party contacts may be made, periodically provide a

[303]It is a violation of federal law to photocopy a revenue agent's badge.
[304]See § 1.5.
[305]IRM 4.75.11.6.1.2 § 1.
[306]See, e.g., § 5.4.
[307]IRM 4.75.11.6.1.2 § 2.
[308]IRC § 7521(b)(2).
[309]IRM 4.75.11.6.1.2 § 3.
[310]IRM 4.75.11.6.2 § 2.
[311]*Id*. § 1.

list of all third-party contacts to the taxpayer, and provide a list of third-party contacts to the taxpayer on request.[312]

(i) Taxpayer Confidentiality Privilege

The attorney–client privilege is extended, in noncriminal cases, to communications between taxpayers and other federally authorized tax practitioners.[313] This privilege is not automatic but must be asserted (orally or in writing) by the taxpayer.[314]

(j) Place of Examination

The examination should, whenever possible, be conducted at the tax-exempt organization's regular place of operations. The examination can be conducted at an alternative site, such as a representative's office.

§ 5.19 EXAMINATION UNFOLDS

An IRS examination of a tax-exempt organization can have several facets: interviews, a tour of the organization's facilities, examination of a variety of documents, analysis of the organization's revenue and disbursements, analysis of expense allocations, an inquiry as to compliance with filing requirements, and the accuracy of the return(s) under examination.

(a) Tour of Facilities

The examiner is required, following the initial interview with the tax-exempt organization that is the subject of the examination, to request a tour of its facilities.[315] The exempt organization is required to provide the examiner with the requested tour.[316] Generally, the principal location of the organization, and any locations acquired during the examination period, should be visited. Nonetheless, the examiner should give consideration to the ''cost effectiveness and practicality'' of taking the tour when ''appropriate alternatives'' are available.[317] These tours are to be conducted with ''knowledgeable individuals.'' The examiner is expected to address, in the course of the tour, large, unusual, or questionable items identified during the pre-contact analysis or interviews. Examiners are expected to schedule and participate in tours in a manner that minimizes disruption of the organization's activities.[318]

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[312]IRC § 7602(c); IRM 4.75.11.6.2 § 3. This rule does not, however, apply with respect to investigations by the IRS's Criminal Investigation unit.
[313]IRC § 7525; IRM 4.75.11.6.3 § 1.
[314]IRM 4.75.11.6.3 § 2.
[315]Reg. § 301.7605-1(d)(3)(iii); IRM 4.75.11.6.5 § 1.
[316]IRM 4.75.11.6.4. Also IRM 4.75.11.6.1 § 8.
[317]IRM 4.75.11.6.5 § 2. The term ''appropriate alternatives'' is not defined.
[318]IRM 4.75.11.6.5 §§ 3, 4, 6.

During the tour, the examiner is to determine if other persons are utilizing the tax-exempt organization's facilities. The following circumstances, if identified, may require documentation: use of space by other organizations, by officers or other individuals for their personal or business use, or by the exempt organization for purposes other than exempt purposes (such as a foodservice facility open to the public).[319]

(b) Examination of Documents

An examination of the books and records of a tax-exempt organization is expected to establish, for the IRS, whether the entity is organized and operated for exempt purposes, and what returns have been or need to be filed by the organization.[320] The examiner should review these books and records to:

- Substantiate and expand information about the organization's activities.
- Verify the accuracy of one or more returns.
- Determine that all required returns have been filed.
- Ascertain whether any taxes due have been paid.[321]

(i) Books and Records. The examiner is required to review (''when appropriate'') the following books and records:

- The tax-exempt organization's governing instruments, including any amendments to them, for the purpose of obtaining a general overview of the purposes and structure of the entity
- The organization's application for recognition of exemption (if any)
- The organization's determination letter (if any)
- Minutes of board, and perhaps other, meetings
- Publications (such as journals, newsletters, brochures, and pamphlets)
- Operating manuals
- Financial records (chart of accounts, general ledger, financial statements, and other supporting documentation)
- Federal returns filed

Other records that may be reviewed include leases and other contracts, and correspondence files.[322]

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[319] *Id*. § 5. The issues of law that may surround these circumstances include private inurement, private benefit, excess benefit transactions, and/or unrelated business. See App. C §§ II D, E, F; IX.

[320] IRM 4.75.11.6.6 § 1.

[321] *Id*. § 2.

[322] *Id*. §§ 3, 4.

(ii) Governing Instruments. The IRS examiner is required to review the examined tax-exempt organization's governing instruments, to identify the following:

- Any amendments that may jeopardize the organization's exempt status
- Any committees with ''special responsibilities''
- The individual(s) who control the organization, both ''ultimately and in day-to-day operations''
- The duties of officers, particularly noting which officials are authorized to disburse funds and make decisions affecting the operations of the organization

If the exempt organization has not sent changes in its governing instruments to the IRS, the examiner is to obtain copies of these amendments and forward them to the records center in Cincinnati to update the organization's determination file. If the organizing documents do not become available after reasonable efforts are made to secure them and there is no indication of improper activities by the organization, the examiner can close the case without reviewing the organizing documents.[323]

(iii) Minutes. The examiner is expected to review the minutes of meetings of the board of directors, and of committees, of the tax-exempt organization under audit, for the year under examination, prior years, and perhaps subsequent years. At a minimum, this review should be of minutes of meetings that took place the year before and the year after the year of the return under examination. The review may be expanded ''as circumstances warrant.'' The examiner is to consider all attachments, exhibits, reports, and correspondence that are referenced in the minutes. If they are not provided with the minute book, they are to be requested as an integral part of the minutes.[324]

The examiner is to ''appropriately consider discussions'' about the following:

- Proposed activities, inasmuch as these activities may be inconsistent with the organization's tax-exempt status or constitute one or more unrelated businesses
- Transactions that may serve the private interests of the trustees, directors, officers, or other individuals in their private capacity
- Transactions with related entities[325]

[323]IRM 4.75.11.6.6.1.
[324]IRM 4.75.11.6.6.2 §§ 1, 3, 4.
[325]*Id*. § 2.

(iv) Publications. The IRS examiner is required to review journals, magazines, newsletters, pamphlets, brochures, annual reports, and other publications of the tax-exempt organization under review, and determine whether the publication furthers the exempt purpose of the organization, contains advertising, and/or contains indications of legislative or political activity.[326]

(v) Web Site. The IRS examiner is to review the tax-exempt organization's web site. This may occur during the preexamination planning process. The procedures note that links to other web sites may be indicative of advertising, joint ventures with for-profit entities, sources of unrelated business income, or private inurement.[327]

(vi) Operating Manuals. The examiner should review the tax-exempt organization's operating manuals, instruction booklets, and any other printed material the organization may have regarding its operations.[328]

(vii) Contracts. The examiner is expected to ''consider reviewing questionable leases and other contracts'' entered into by the tax-exempt organization, particularly those with officers or other related parties. He or she should determine whether any of these arrangements is giving rise to private inurement or is inconsistent with the organization's exempt status. In reviewing agreements, the examiner is to determine if they are arm's-length contracts and if the payments pursuant to them are reflective of fair market value.[329]

(viii) Correspondence Files. IRS examiners are to consider reviewing the correspondence files of the tax-exempt organization. The IRS views correspondence as consisting of four categories:

1. Letters soliciting contributions that identify projects to be financed or supported
2. Correspondence relating to use of funds that identifies the type of activities and/or organizations being supported
3. Correspondence that identifies other activities carried on for or on behalf of the exempt organization or related parties
4. Correspondence with the IRS

The examiner is to request recent correspondence the exempt organization has had (and, presumably also, is having) with the IRS. He or she is expected

[326]IRM 4.75.11.6.6.3.
[327]IRM 4.75.11.6.6.4.
[328]IRM 4.75.11.6.6.5.
[329]IRM 4.75.11.6.6.6.

to take ''appropriate actions'' to help resolve any outstanding notices or other problems the organization may be having with the agency.[330]

(ix) Financial Records. As the procedures note, a review of the financial information concerning a tax-exempt organization ''generally reveals important information about the organization's activities.'' Also, this review enables the examiner to determine whether the information reported on one or more returns is correct. Examiners are to consider the following procedures:

- Reconciling the exempt organization's books and records to the return(s)
- Comparing prior and subsequent year income, expenses, assets, and liabilities[331]
- Reviewing the chart of accounts
- Reviewing the year-end trial balance
- Reviewing the auditor's report
- Reviewing the audited financial statements and management reports
- Analyzing income and expenses
- Analyzing the balance sheet
- Ensuring that accurate return(s) have been filed

When a taxpayer submits ''unorganized records,'' the IRS's position is that the burden is on the taxpayer to organize them, and prepare ''summaries and reconciliations.''[332]

As to the first of these requirements,[333] the procedures state that the reconciliation is necessary to ''ensure [that] all transactions reported on the return have been recorded in the books.'' (Presumably, the reverse is also the case.) If the return cannot be reconciled to the organization's books and records, the procedures observe that ''this is a very good indication that internal controls may be inadequate or that proper accounting procedures are not being used.''[334]

The examiner is to review the *return reconciliation workpapers*, which generally consist of ''year-end trial balances after any adjusting (and consolidating, if applicable) entries.'' The examiner should also review the adjusting journal entries, inasmuch as they ''often can be important indicators of unusual transactions or expenditures.'' In addition, the examiner should review budget

[330]IRM 4.75.11.6.6.7.

[331]The objective is to identify ''any large or questionable differences'' (IRM 4.75.11.6.7.3 § 1).

[332]IRM 4.75.11.6.7.

[333]The word *requirements* is used because, although the procedures at one point state that the examiner ''should'' consider the reconciliation (*id*. § 2), at another point they state that the examiner ''should'' engage in the reconciliation (IRM 4.75.11.6.7.2 § 1).

[334]IRM 4.75.11.6.7.2 § 1.

reports prepared by the organization, in that ''large variances between actual and budgeted amounts may indicate diversion of funds or other problems requiring further analysis.'' Moreover, as to the third of these requirements, the examiner is to review the chart of accounts for ''unusual amounts or accounts that should appear but are absent''; this chart also should be of assistance to the examiner in his or her review of the general ledger. Overall, the examiner is to ''identify and explain any material differences'' between the organization's books and return.[335]

As to the review of the chart of accounts, the procedures note that it is ''generally necessary to identify certain accounts for further analysis to determine the source of the revenue or expenditures.'' The procedures observe that an organization's ''utilization of its resources and expenditures are important indicators of an organization's programs and activities.''[336] In reviewing accounts, the examiner is expected to adhere to the following procedure:

- Review the year-end adjusting trial balance or similar summary of year-end general ledger account balances and select large, unusual, or questionable accounts for further analysis.
- Review ''detailed transactions'' in the general ledger for selected accounts.
- Select a sample of detailed transactions as warranted and trace them to journals or other supporting documentation.
- Discuss the items needing additional explanation with the organization.
- Request any additional documents that may be necessary to adequately determine the impact of a particular transaction on the organization's exempt status or tax liability.

In general, the examiner is to use his or her judgment in deciding which accounts, if any, maintained by an exempt organization to select for additional analysis.[337]

The examiner is required to always review the accountant's tax reconciliation workpapers. The procedures define the phrase *tax reconciliation workpapers* as the workpapers ''used in assembling and compiling financial data preparatory to placing it on a return.'' The procedures observe that ''typically'' these workpapers include the ''final trial balance after adjusting entries and can be used to trace financial information to the return.''[338] The procedures also observe that these workpapers provide a ''good starting point'' for reconciling the return to the books.[339]

[335]IRM 4.75.11.6.7.2 §§ 2–4, 4.75.6.7.3, 4.75.11.6.7.4.
[336]IRM 4.75.11.6.8 § 3.
[337]*Id*. § 5.
[338]IRM 4.75.11.6.7.1 § 1.
[339]IRM 4.75.11.6.7.6 § 1.

Tax reconciliation workpapers, unlike audit workpapers, are to be requested by the examiner at the beginning of the examination. There is a need for these workpapers, the procedures continue, since they ''include the final balance tying the return to the general ledger and other analyses necessary to complete the return.'' The procedures note that, ordinarily tax reconciliation workpapers are prepared and provided by the taxpayer; nonetheless, if these workpapers are unavailable from the taxpayer, the examiner is to seek, from the accountant, access to them.[340]

In ''unusual circumstances,'' the examiner may request access to the audit workpapers. The procedures define the term *audit workpapers* to mean workpapers ''retained by the independent accountant as to the procedures followed, the tests performed, the information obtained, and the conclusions reached pertinent to his/her examination.'' These workpapers may include work programs, analyses, memoranda, letters of confirmation and representation, abstracts of organization/plan documents, and schedules or commentaries prepared or obtained by the auditor. The procedures state that these workpapers ''provide an important support for the independent certified public accountant's opinion as to the fairness of the presentation of the financial statements, in conformity with generally accepted accounting principles and demonstrate compliance with the generally accepted auditing standards.''[341]

The procedures provide that the accountant's audit workpapers should ''normally be used only when such factual data cannot be obtained from the taxpayer's records and then only as a collateral source for factual data.'' The examiner is to limit a request for audit workpapers to only those portions that are ''material and relevant'' to the examination; whether an item is *material* is a matter for the examiner's judgment based on his or her evaluation of the facts and circumstances of the case.[342]

The examiner is expected to review the tax-exempt organization's audit reports (external and internal) as well as, as noted in the sixth of these requirements, the management letter from the exempt organization's accounting firm. The procedures observe that this letter ''provides useful information on internal controls and the organization's accounting procedures.'' The exempt organization, however, is not required to produce this letter.[343] Other documents to be reviewed in this context are the organization's annual report and reports filed with other regulatory agencies, such as the Department of Health and Human Services and the Department of Education.[344]

In reference to the foregoing, which calls on the examiner to look for *unusual* items, the procedures offer three interpretations of that term:

[340] *Id*. § 2.
[341] IRM 4.75.11.6.7.1 § 2.
[342] IRM 4.75.11.6.7.6 §§ 3, 4.
[343] IRM 4.75.11.6.7.5 § 1.
[344] *Id*. §§ 2, 3.

- *Unusual in amount*. Amounts that are unusual in amount are those that are much larger or smaller than typical entries to an account.
- *Unusual by source*. The term *source*, in this regard, means the journals from which the account was posted, as indicated in the folio column. There is a ''normal source pattern'' for most postings; deviations from this norm should be investigated (such as a payroll entry in the office supplies account).
- *Unusual by nature*. Items that are unusual by nature include credit entries in accounts usually containing only debits or accounts that exist at the beginning of the year but do not exist at year's end.[345]

(c) Sampling Techniques

The IRS is of the view that the process of examining the books and records of a tax-exempt organization can be ''substantially enhanced and improved'' through the appropriate use of sampling techniques. From the agency's viewpoint, there are two basic types of sampling techniques: judgment sampling and statistical sampling.[346]

Judgment sampling requires examiners to use professional judgment in performing the sampling procedure and in evaluating the results of the sample.[347] One type of judgment sampling is *block sampling*, where, for example, the examiner evaluates groups of continuous items selected from an account balance or class of transactions[348] or selects all items in a selected numerical or alphabetical sequence.[349] Another type of judgment sampling is *dollar limitation sampling*,[350] which is a method by which a minimum dollar amount is selected, thereby creating a sample consisting of all items exceeding that dollar amount. The purpose of this type of sampling is to prevent the examiner ''from wasting time examining small, insignificant amounts.''[351]

Statistical sampling is a procedure that is used to choose a portion of the whole to ''make a statement'' about the entire body of information. Using this sampling technique, ''there is no way for the individual doing the sampling to impose their [*sic*] judgment on the selection process.''[352] Examiners are advised to seek assistance before attempting statistical sampling, by discussing the

[345] *Id*. § 4.
[346] IRM 4.75.11.6.8.1.
[347] IRM 4.75.11.6.8.2 § 1.
[348] As an illustration of this type of block sampling, an examiner selects one month of travel expenses to reach a conclusion about the organization's travel expenses for the year.
[349] As an illustration of this type of block sampling, an examiner samples an organization's gross receipts for a year by selecting the months of January, September, and December.
[350] This type of judgment sampling is also known as *cutoff sampling*.
[351] IRM 4.75.11.6.8.2 §§ 2, 3.
[352] IRM 4.75.11.6.8.3 §§ 1, 2.

facts and circumstances with their manager and determining if a request for a computer audit specialist is necessary.[353]

The burden of proof is on the IRS in a court proceeding when the agency reconstructs any item of a taxpayer's income solely using statistical information on unrelated taxpayers. This is the case irrespective of whether the taxpayer does or does not cooperate or provides evidence.[354]

(d) Income Analysis

The examiner is required to include a review of the tax-exempt organization's income to determine the ''size, extent and nature'' of that income. The purposes for analyzing an exempt organization's income are to determine if it supports the organization's exempt purpose, is from related parties and may constitute one or more forms of private inurement,[355] is from an unrelated business,[356] and/or is properly classified for purposes of the public support tests.[357]

The examiner is expected to select from the trial balance large, unusual, or questionable income accounts for further analysis. Also, he or she should select accounts that may be sources of unrelated business income or private inurement. The examiner should consider examining contributions and grants, program service revenue, other income sources identified during the pre-audit phase, miscellaneous or other income accounts, fundraising activities, asset sale, and rental income. The examiner is to identify solicitations for charitable contributions and ensure that the exempt organization has complied with all notification and disclosure requirements.[358] In addition, the examiner should determine whether the exempt organization solicited any contributions in which the donor received goods or services in consideration for the payment or transfer of property.[359]

(e) Disbursement Analysis

The IRS examiner is expected to review the disbursements of a tax-exempt organization. The purposes for analyzing the disbursements of an exempt organization are to determine whether expenditures are made in furtherance of the organization's exempt purposes, identify potential private inurement and/or private benefit, identify expenditures made in attempts to influence

[353] *Id*. § 3.
[354] IRC § 7491; IRM 4.75.11.6.8.3 § 4.
[355] See App. C § II D. Also, in this context, the private benefit and/or intermediate sanctions rules may be involved and, if the entity being examined is a private foundation, the self-dealing rules. See App. C §§ II E, F; V F.
[356] See *id*. § IX.
[357] IRM 4.75.11.7, 4.75.11.7.1 § 2. See App. C § V C.
[358] IRM 4.75.11.7.1 §§ 1, 3; 4.75.11.9.6 §§ 2, 3. See App. C § VIII.
[359] IRM 4.75.11.7.2. See, e.g., App. C § XIV C.

legislation[360] or engage in political activity,[361] identify any tax liabilities, determine filing requirements, and determine the proper allocation of expenses for purposes of the unrelated business rules.[362]

To detect private inurement, an excess benefit transaction,[363] or other ''serving of private interest,'' the examiner is expected to identify the members of the tax-exempt organization's board of trustees or directors, its officers, and key employees.[364] Any ''business relationships or other dealings with these individuals should be carefully analyzed to determine if they provide inappropriate benefits.''[365]

The examiner should determine the reasonableness of total compensation paid or accrued to ''principal officers.''[366] He or she is to take into consideration any compensation claimed under a heading other than salaries, such as contributions to pension plans, payments of personal expenses, year-end bonuses, and use of an automobile. The examiner should ''be alert'' to ''multiple entity situations'' in which compensation is split between two or more related corporations ''making the aggregate amount paid excessive.''[367]

The examiner should review the following accounts, inasmuch as they may disclose efforts to influence legislation: advertising, printing, promotion, outside services, legal and professional fees, and/or miscellaneous expenses. In an instance of an examination of a membership organization that is not a charitable entity, the examiner should review these aspects of an organization's legislative activities: the existence and extent of its involvement in grassroots lobbying or lobbying in support of or opposition to legislation that is not directly connected with the trade or business of its members; whether the activities were financed from dues and/or other general funds, or by special assessments of the members; and/or whether part or all of the dues or special assessments for the year(s) involved were or were not properly deductible by the members as business expenses.[368]

(f) Filing Requirements

The IRS examiner should review contract labor, repairs and maintenance, legal, consulting, and similar accounts for potential independent contractor

[360]See App. C § III.
[361]See *id*. § IV.
[362]IRM 4.75.11.8. See App. C § IX.
[363]See App. C § II F.
[364]These individuals are *insiders* or *disqualified persons*, depending on the applicable body of law. See App. C § II D, F.
[365]IRM 4.75.11.8.1 § 1.
[366]In fact, however, this analysis should extend beyond ''principal officers'' to any persons referenced in text accompanied by *supra* note 364.
[367]IRM 4.75.11.8.1 § 2. This type of multiple-entity situation can also arise where the entities are unrelated (there are only 24 hours in a day).
[368]IRM 4.75.11.8.2. See App. C § III C.

filing requirements (Form 1099). Payments to individuals (such as prizes and fees) that may result in a ''discrepancy adjustment'' and additional compensation in the form of expense accounts should be considered. The examiner should also analyze travel and other expense allowances. The procedures note that, if the organization does not require its employees to file expense accounts, the payments should be included in the individuals' gross income.[369]

(g) Expense Allocations

In cases where a tax-exempt organization's unrelated business income is identified, the examiner is responsible for ensuring that expenses are allocated on an appropriate basis and the deductibility of any losses.[370] The procedures observe that an exempt organization is not required to use any specific allocation method but rather that the only requirement is that the method reasonably approximate the costs incurred to generate the unrelated income. There are special rules concerning exempt social clubs' allocation of expenses in situations involving the dual use of facilities.[371]

(h) Balance Sheet Analysis

The IRS examiner is expected to review and ''comment on any unusual balance sheet items.'' The purposes for analyzing the balance sheet of a tax-exempt organization include the identification of any private inurement, private benefit, and/or excess benefit transactions, and any assets associated with unrelated business.[372]

The examiner is to analyze the changes in a tax-exempt organization's net assets/fund balances and net worth, and reconcile any increases or decreases with the income and expense statements. In reviewing an exempt organization's assets, the examiner should:

- Analyze any receivables with directors, officers, or other persons in a position of control[373] to determine whether the arrangements serve private interests.[374]
- Look for automobiles, houses, and other assets that could be used, for personal ends, by persons in control.
- Look for rental property or property used in an unrelated business.

[369]IRM 4.75.11.8.3.
[370]See App. C § IX H.
[371]IRM 4.75.11.8.4.
[372]IRM 4.75.11.9.
[373]See *supra* note 364.
[374]The procedures note that a ''lack of intent to fulfill the obligations on the part of an office or director could have income tax consequences'' (to the exempt organization and/or the officer or director). IRM 4.75.11.9.1 § B.

- Look for investments that may be used to generate unrelated business income.
- Analyze any ''dispositions'' for the possibility of private inurement or private benefit.
- Identify any loans that became delinquent or foreclosed during the examination year(s).
- Identify receivables written off to determine if they were from an official.[375]

(i) Tax Liabilities

The examiner should determine if the tax-exempt organization is liable for one or more taxes and, if so, determine the correct amount of the tax. These taxes include those imposed on or in connection with unrelated business income,[376] private foundations,[377] lobbying activities,[378] political activities,[379] excess benefit transactions,[380] and gaming activities.[381]

(j) Accuracy of Returns

The examiner is responsible for ensuring that the tax-exempt organization under examination has filed a complete and accurate return for each of the year(s) involved (assuming a return is required). Because the annual information return is open to public inspection,[382] it is ''important that the information be complete and correct.'' Any schedules or other information omitted from the originally filed return should be secured by the examiner and attached to the return. The procedures observe that information that is ''commonly'' omitted from annual information returns are schedules, particularly asset schedules; list of program service accomplishments; names and addresses of trustees, directors, and officers; and ''answers to all applicable questions.''[383]

(k) Penalties

The primary responsibility for asserting tax penalties against a tax-exempt organization under examination rests with the examiner. The workpapers should fully document the consideration, development, and assertion or

[375]IRM 4.75.11.9.1.
[376]See App. C § IX.
[377]See *id*. § V.
[378]See *id*. § III.
[379]See *id*. § IV.
[380]See *id*. § II F.
[381]IRM 4.75.11.9.2. See App. C § XII A.
[382]See *id*. § VIII A.
[383]IRM 4.75.11.9.3.

non-assertion of all applicable penalties. The case file should include the facts surrounding the issue, applicable law, application of the law to the facts, the audit conclusion, and the position of the exempt organization on the matter. The examiner should solicit an explanation from the organization as to any delinquencies subject to the assessment of penalties.[384]

The group manager is generally required to approve a penalty assertion in writing before the examiner discusses it with a representative of the tax-exempt organization.[385] The following penalties, however, do not require managerial approval: failure to file or pay (except where fraud is involved),[386] failure to pay estimated tax for individuals,[387] failure to pay estimated tax for corporations,[388] and any penalties automatically electronically calculated.[389]

The examiner must properly identify and address potential ''badges of fraud.'' When fraud is uncovered, the examiner should discuss the matter with the manager and develop an action plan ''as soon as possible to document firm indications of fraud.''[390]

(l) Issue Development

Examiners are responsible for *issue development*, which in this context means determining whether the tax-exempt organization being examined satisfies the requirements for exemption, has correctly reported any tax liabilities, and/or has filed all required information and/or tax returns.[391] When a potential exempt organization issue is identified, the examiner is required to do the following:

- Determine if there are any ''unique considerations or procedures'' applicable to the issue.
- Thoroughly develop and document all of the facts pertaining to the issue.
- Engage in research to identify the applicable law and ''interpret its meaning in light of congressional intent.''
- In a ''fair and impartial manner,'' apply the law based on the facts and circumstances.

[384]IRM 4.75.11.9.4 §§ 1–3.
[385]IRC § 6751.
[386]IRC § 6651.
[387]IRC § 6654.
[388]IRC § 6655.
[389]IRM 4.75.11.9.4 § 4. The IRS has the burden of proof in a court proceeding (involving an individual) when the issue is a penalty or an addition to tax or an additional amount imposed by law (IRC § 7491(c)). IRM 4.75.11.9 §§ 5, 6.
[390]IRM 4.75.11.9.5.
[391]IRM 4.75.13.1 § 1. In fact, there is more to issue development, such as a determination as to whether the exempt organization has met and is meeting required notice and disclosure requirements (see App. C § VIII).

Issues identified by the IRS examiner should be developed ''to the point [where] the pertinent facts or data gathered for the identified issues were not overdeveloped or underdeveloped.'' The examiner should request additional information for any areas needing further clarification.[392]

The examiner may find it necessary during the course of the examination to obtain additional records, documents, or other clarifying evidence concerning the tax-exempt organization under review. In that situation, he or she ''generally'' should prepare an IDR as the means to secure the information. The examiner should only request information necessary to resolve the issue(s) or area(s) under consideration. The IDR should be clear, concise, and legible; dated; include a due date for the information requested; and indicate the manner in which the exempt organization will return the information (such as at the time of a subsequent appointment, by mail, or picked up by the examiner).[393]

(m) Exempt Organization–Caused Delays

In some instances, during an examination, an IRS examiner will request additional information to be provided by the tax-exempt organization under review, with the information to be provided within a certain timeframe. If the exempt organization does not provide the information within the specified time, the examiner will attempt to contact the organization, preferably by telephone. If that proves infeasible, the examiner will mail a copy of the IDR to the organization; this request will also include a response date.[394]

The examiner is required to allow a ''sufficient amount of time'' for the tax-exempt organization to respond to this IDR. At the same time, the examiner must always be aware of statute of limitations and audit cycle considerations.[395] If two attempts to obtain the information fail to result in success, the examiner will turn to his or her group manager to obtain assistance in securing the requested information. The examiner and group manager will schedule a meeting, including the exempt organization, to ascertain whether the information is or will be forthcoming. If the organization persists in being uncooperative, the group manager will likely commence the process leading to issuance of a summons.[396]

(n) Developing and Documenting Facts

The procedures state that a quality examination[397] by the IRS includes obtaining evidence bearing on the tax-exempt organization's tax status or

[392]IRM 4.75.11.9.7.
[393]IRM 4.75.11.9.7.1.
[394]IRM 4.75.11.9.7.2 § 1.
[395]See §§ 5.4(g), 5.5.
[396]IRM 4.75.11.9.7.2 §§ 2, 3.
[397]See § 5.18(b)(i).

tax treatment by inspecting its premises, examining its books and records, and directly questioning the organization's representatives, including management.[398] A ''comprehensive'' examination by the IRS of an organization's books and records includes (1) determining whether its records reflect and explain its activities and expenditures, and commenting on ''questionable, unusual or unclear'' items;[399] (2) testing the organization's books and records for ''reliability'' and documenting the results of these tests in the workpapers; (3) evaluating the manner in which the organization is utilizing its assets and other resources; (4) determining the source and nature of the organization's receipts; (5) identifying ''unusual'' transactions and documenting the purpose of the transactions;[400] (6) determining the relationships of all persons doing business with the organization and whether the private interests of these persons ''are being served at the organization's expense''; (7) evaluating purchases, sales, leases, and ''sharing arrangements''; and (8) securing an accurate valuation of property.[401]

(o) Collecting and Recording Facts

The examiner is expected to use judgment when gathering facts to support a ''given position.'' The emphasis in the procedures in this regard is on relevance. Thus, the examiners are reminded that ''[w]eight and file thickness are not necessarily a sign of effective fact gathering.'' Indeed, ''[e]very document appearing in the file should have some relevance or it should be omitted.'' The examiner is expected to secure documents that describe an activity or identify an unrelated business issue (such as the annual report, brochures, and/or a sample of newsletters), and copies of checks and agreements directly relating to an issue. The examiner is not likely to keep copies of financial statements, minutes, leases, and the like (unless, of course, they are relevant).[402]

Thus, the extent to which an examiner will collect and record facts will depend on the facts and circumstances of the case. For example, an examiner discovers, by reviewing a tax-exempt charitable organization's publications, that it is engaging in substantial legislative activity; the examiner is defending

[398] IRM 4.75.13.2 § 1.

[399] An example is provided concerning an examiner who lists, in his or her workpapers, the names and salaries of several highly compensated employees of an exempt organization. The mere listing of these ''questionable'' salaries is not by itself of much assistance in developing facts unless the listing is accompanied by an analysis of the duties and responsibilities of the individuals (*id*. § 2A). In fact, however, there are other factors to take into consideration in this regard.

[400] It is noted that ''useful sources'' of this information include the adjusting entries in the general journal and discussions of unusual transaction in minutes of the meetings of the organization's board of directors or perhaps committees (*id*. § 2E).

[401] IRM 4.75.13.2 § 2.

[402] IRM 4.75.13.2.1 § 1.

an unagreed issue. He or she is expected to secure copies of all newsletters and other publications reflecting the attempts to influence legislation, irrespective of the volume. The examiner is reminded that, should the case reach Appeals, the Appeals Officer must have adequate documentation to uphold the IRS's position.[403]

Overall, the policy of the IRS is to be certain that its ''technical positions [are] well thought out, the facts [are] appropriately developed, audit conclusions [are] well supported, and the case file [is] well documented.''[404]

(p) Preparation and Issuance of Summons

Although an examiner is to attempt to obtain information from a tax-exempt organization under review on a voluntary basis, in certain circumstances an examiner may have occasion to issue a summons to obtain the records that are necessary to conduct an ''adequate'' examination.[405] Examiners are to consider all ''surrounding circumstances'' before resorting to issuance of a summons; they are to ''analyze each situation in the light of its particular facts and circumstances, and then weigh the importance of the desired information.''[406]

IRS agents have the authority to issue most summonses and perform related functions.[407] Nonetheless, the group manager or other supervisory official above that level must authorize, in advance, the issuance of the summons.[408]

(q) Sharing of Issues

The procedures place importance on the sharing, by the examiner, of the potential issue or issues with one or more representatives of the tax-exempt organization under review ''as soon as possible.'' This discussion of the issue(s) ''can lead to an early resolution of the case.'' The examiner is also to consider providing a representative of the exempt organization with a written summary of potential issues on a Notice of Proposed Adjustment (Form 5701) (NOPA); this notice should include the issues, facts, law, and the examiner's position. Presenting an exempt organization representative with a NOPA, however, does not relieve the examiner of the responsibility for discussing the issue(s) with the exempt organization's representative(s).[409]

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[403] *Id*. § 2.
[404] IRM 4.75.13.4.1 § 2.
[405] See § 1.8.
[406] IRM 4.75.13.2.2 §§ 1, 3.
[407] Delegation Order No. 4, Authority 3.
[408] IRM 4.75.13.2.2 § 2.
[409] IRM 4.75.13.3.

§ 5.20 BURDEN OF PROOF

The burden of proof in a court proceeding shifts from the taxpayer involved to the IRS, if the taxpayer produces credible evidence regarding the factual issues relevant to a determination of tax liability and the taxpayer has met all substantiation requirements; maintained all required records; cooperated with any reasonable request from the IRS for information, documents, and witnesses; exhausted all administrative remedies, including appeal rights; and met certain net-worth qualifications (in the case of a corporation, trust, or partnership).[410] Also, the burden of proof is on the IRS in a court proceeding when the agency reconstructs any item of the taxpayer's income using solely statistical information on unrelated taxpayers.[411]

§ 5.21 REVOCATION OF TAX EXEMPTION

The procedures state that the status of a tax-exempt organization[412] that is exempt by reason of being a charitable entity[413] cannot be modified from one section of the Internal Revenue Code to another.[414] That is, if the organization fails to meet one or more of the requirements associated with charitable status, its exempt status must be revoked.[415]

Faced with evidence that a tax-exempt organization has engaged in an activity, in a subsequent year, that is inconsistent with its exempt status, the examiner is required to conduct an ''immediate examination'' of the organization. That is, ''it is not necessary to wait until a[n] [annual information] return is filed by the organization to expand the examination.''[416]

§ 5.22 EFFECTIVE DATE OF REVOCATION OR MODIFICATION

The procedures state that, generally, the ''effective date of a revocation or modification of exempt status is the date the organization first failed to qualify for exemption under the specific subsection of IRC § 501 stated in its most

[410]IRC § 7491(a)(1). This body of law applies to income, estate, gift, generation-skipping transfer, and employment taxes. IRM 4.75.13.4 §§ 1, 2.
[411]IRC § 7491(b); IRM 4.75.13.4.1.3 § 1
[412]That is, an organization that is exempt pursuant to IRC § 501(a).
[413]That is, an organization that is described in IRC § 501(c)(3).
[414]For example, the examiner cannot convert an IRC § 501(c)(3) entity to an IRC § 501(c)(4) entity. In practice, however, at least in settlements, conversions of this nature are made. Nonetheless, the IRM repeatedly refers to ''revocation or modification'' of tax exemption, without explaining what the latter may mean.
[415]IRM 4.75.13.5.1. Also IRM 4.75.13.5.8 § 5, where the procedures also state that an organization, to have converted tax-exempt status on a basis other than IRC § 501(c)(3), must file an application for recognition of exemption (usually Form 1024); as a matter of law, however, that is not required (see App. C § VI A).
[416]IRM 4.75.13.5.2. See § 1.7.

current determination letter.''[417] This statement, however, is incorrect. Indeed, the correct rule is subsequently stated: The effective date of revocation is the first day of the year in which the ''act'' (or acts) that caused the organization to fail to qualify for exemption first occurred,[418] assuming that date can be ''substantiated.''[419] (A revocation or modification of an organization's exempt status may qualify for relief, in which case the modification or revocation of exemption operates only on a prospective basis.[420])

If there is evidence that an organization has failed to function in conformity with one or more of the applicable requirements for tax exemption, the examiner is required to attempt to establish the date the organization first ceased to qualify for exempt status.[421] The procedures state that ''[i]t is relatively easy to determine the effective date of a revocation or modification that is based on the occurrence of a single act, since the effective date [of the revocation or modification] is the first day of the year in which the act occurred.''[422] The procedures continue: ''It is more difficult to determine the effective date of a revocation or modification if the revocation is based on an ongoing activity.'' In this case, the examiner ''must attempt to determine the date the activities would have first caused the organization to fail to qualify for exemption.''[423] Except in situations where the act that triggered the nonqualification for exemption occurred in the distant past, it would seem that it is no more difficult for an examiner to determine the effective date for revocation of exemption when the activity is an ongoing one than when the date comes into being as the consequence of a single act.

The examiner is to consider use of some or all of the following examination techniques to determine this effective date: Interview the officers, employees, and/or members of the organization; inspect the prior-year returns; and/or review the determination file (if it is available). If the examiner determines that the organization ''probably'' ceased to qualify for exemption during a prior year, he or she should, once approval of the group manager is obtained, expand the examination to include the prior year (unless the applicable statute of limitations has expired).[424]

IRS relief[425] is available with respect to revocation, modification, unrelated business income, excise taxes, private letter ruling, or technical advice issues. If the facts show that the original ruling or determination letter recognizing

[417]IRM 4.75.13.5.3 § 1.
[418]IRM 4.75.13.5.3.1 § 2.
[419]*Id*. § 5. The term *substantiated*, as used in this context, is not defined.
[420]See § 1.12.
[421]IRM 4.75.13.5.3.1 § 1.
[422]*Id*. § 2. That, however, is a non sequitur: The effective date rule is accurate (see text accompanied by *supra* note 418), but that does not make it any easier to identify the offending act.
[423]IRM 4.75.13.5.3.1 § 3.
[424]*Id*. §§ 3, 4.
[425]IRC § 7805(b). See § 1.12.

tax exemption was correct under the facts presented by the organization and the law when the letter was issued, but a subsequent change in the facts or law precludes the organization from continued recognition of exemption, revocation of exemption will be effective as of the beginning of the first tax year in which the organization altered its operations or the facts changed. Under these circumstances, there is no need for the organization to seek relief.[426]

If, however, the facts show that the organization was never entitled to recognition of exemption, notwithstanding issuance by the IRS of a determination letter because of an omission or misstatement of material facts by the organization, the revocation of exemption would ordinarily apply retroactively to the beginning of the organization's first year. In such cases, relief is generally not available.[427]

If recognition of tax exemption was erroneous because of a misinterpretation of the applicable law by the IRS, causing the organization to rely on its exemption letter, the examiner should recommend relief in determining the date of revocation. The matter of this relief may be raised by the examiner or by the organization in requesting the examiner to recommend relief. The examiner is required to advise an organization, the exemption of which may be revoked, of the relief rules, if only to relate why relief is not being recommended.[428]

All cases in which relief has been requested, whether recommended by the area manager or the Appeals office, or by the organization, must be referred to Exempt Organizations Technical. The area manager is to inform the organization that the request for relief is being referred to EO Technical and indicate the recommended effective date of the revocation (if one has been proposed).[429]

§ 5.23 TECHNICAL ADVICE

When a tax-exempt organizations issue is identified, the IRS examiner is required to determine whether the issue is a mandatory technical advice issue or otherwise warrants a request for technical advice.[430] The procedures define *technical advice* as ''advice or guidance in the form of a memorandum furnished by Exempt Organizations Technical, in response to any technical or procedural question that develops during any proceeding on the interpretation and proper application of tax law, tax treaties, regulations, revenue rulings, notices, or other precedent, to a specific set of facts.'' These proceedings are the examination of a taxpayer's return, the consideration of a taxpayer's claim for refund or credit, or any other matter involving a specific taxpayer.[431]

[426]IRM 4.75.13.5.3.2 § 1.
[427]*Id*. § 2.
[428]*Id*. §§ 3, 4.
[429]IRM 4.75.13.5.4 §§ 1, 5.
[430]See § 1.9.
[431]IRM 4.75.13.5.5 § 1.

Given a specific set of facts, technical advice should be requested where the statutory law and regulations are not clear on the issue and there is no published precedent for determining the proper treatment of the issue, there is a lack of uniformity regarding the disposition of the issue, a ''doubtful or contentious'' issue is involved in a number of cases, the issue is unusual or complex, and securing technical advice would be in the best interest of the IRS. A technical advice memorandum should not be requested where the issue is frivolous, the area office is currently considering an identical issue involving the same organization, or the same issue involving the same organization is in a docketed court case. For this purpose, a *frivolous issue* is an issue ''without basis in fact or law, or that espouses a position which has been held by revenue rulings . . . or the courts to be frivolous or groundless.'' If the examiner determines that technical advice should be requested, he or she must first discuss the issue with the group manager and exempt organization as soon as possible.[432]

§ 5.24 TERMINATIONS

A tax-exempt organization can terminate by dissolving its structure and properly distributing its assets. By contrast, the IRS cannot initiate the termination of an organization. An examiner may be assigned the examination of an organization that has terminated its existence or an organization may decide to terminate while the examination is in progress. If an organization has terminated and not previously notified the IRS of that fact, the examiner is to obtain the necessary information so as to update the Exempt Organization Business Masterfile to reflect the correct status of the organization.[433]

If the terminating organization is a corporation, the examiner is to secure a complete copy of the articles of dissolution and proof of the filing of it with the state. In the case of an unincorporated association, the examiner is to obtain a copy of the resolution as to termination (indicating the termination date) signed by at least two officers; if the entity is a trust, the trustees must sign the resolution. If the organization was a charitable entity and was terminated during or after its advance ruling period[434] and it did not receive a definitive ruling,[435] the examiner is required to determine the organization's public charity/private foundation status as part of the examination.[436]

If the tax-exempt organization was a charitable entity, the examiner is to obtain a statement, signed by an officer of the organization, regarding the

[432]*Id*. §§ 3–5.
[433]IRM 4.75.13.5.6 §§ 1, 2.
[434]See App. C § VI A.
[435]See *id*.
[436]IRM 4.75.13.5.6.1 § 1.

disposition of its assets that were on hand at the time of dissolution. The examiner is to determine whether the assets were properly distributed for charitable purposes, to a state or local government for public purposes, and/or to the federal government.[437] If the assets were not distributed properly, the examiner is required to ask the organization to recover the assets and redistribute them in accordance with the tax law requirements. Also, the examiner is to secure any final returns that are due but not filed.[438]

§ 5.25 INADEQUATE RECORDS

Every person liable for any tax imposed by the federal tax law, or for the collection of tax, is required to keep such record, render such statements, make such returns, and comply with such rules and regulations as the IRS may prescribe.[439] The IRS may require any person, following adequate notice, to make such returns, render such statements, or keep such records to show whether the person is liable for a tax.[440]

In general, a tax-exempt organization must file an annual information return and, in that connection, keep such records, render such statements, make such other returns, and comply with such rules and regulations as the IRS may prescribe.[441] Exempt organizations are required to maintain books and records that are needed to substantiate the information required by the return filing requirement.[442]

The IRS issues *inadequate records notices* to alert taxpayers that their record-keeping practices are deficient and must be improved to meet the requirements of the law. The issuance of one of these notices may result in a follow-up examination or compliance check; this notice is a tool to enforce taxpayer compliance with the requirement to keep adequate records for filing complete and accurate returns.[443] The determination by the IRS as to whether a taxpayer has maintained adequate records or has complied with a record retention agreement is a matter of judgment based on the facts and circumstances of the particular case, with the factors the examiner is to consider including prior history and ''present degree of noncompliance,'' indications of willful intent, evidence of refusal to keep records, other evidence of harm to the government, the

[437]If the organization is a private foundation, the examiner is to consider the rules pertaining to termination of private foundation status (see App. C § V F). Likewise IRM 4.75.13.5.8 § 6.
[438]IRM 4.75.13.5.6.1 §§ 2–4, 6. The procedures also require the examiner to determine if the asset distribution was in accordance with (if applicable) IRC § 501(c)(9) (see App. C § I P), (12) (see *id*. § I R), (16) (see *id*. § IV), (19) (see *id*. § I X), as well as (if applicable) IRC § 501(e) (see *id*. § I DD) or 501(f) (see *id*. § I EE). IRM 4.75.13.5.6.2.
[439]IRC § 6001; IRM 4.75.13.5.7 § 1 (see App. C § XII D).
[440]IRM 4.75.13.5.7 § 2.
[441]IRC § 6033; IRM 4.75.13.5.7 § 3 (see App. C § VII A).
[442]Reg. § 1.6001-1(c); IRM 4.75.13.5.7 § 4.
[443]IRM 4.75.13.5.7.1 § 1.

probability that poor recordkeeping will result in significant changes to the return, the likelihood that compliance can be enforced if the taxpayer fails or refuses to correct the inadequacies, and ''anticipated revenue in relation to the time and effort required to obtain compliance.'' If the taxpayer has failed to substantially comply with the law requiring maintenance of adequate books and records, the examiner is to discuss the inadequacies with the group manager in determining whether to issue an inadequate records notice.[444]

The procedures require that, when discussing the inadequate records issue with the taxpayer, the examiner is to avoid criticizing the work of the taxpayer's employees, accountants, or lawyers in a way that would suggest ''wrongdoing or negligence''; focus on explaining why the taxpayer's books and records are inadequate; and explain the steps that need to be taken to bring them into compliance with the requirements of the law.[445]

When the examiner and group manager have agreed that an inadequate records notice is appropriate, the examiner will prepare an agreement to maintain adequate books of account and records (Form 2807), and attempt to obtain the taxpayer's execution of the agreement. The examiner will serve the agreement on the organization in person or by certified mail. If the taxpayer refuses to sign the agreement, the matter is to be discussed with the group manager. If the taxpayer executes the agreement, the IRS will issue the inadequate records notice, summarizing why the records are inadequate, and list the specific books of account and records the taxpayer must maintain. If an agreement is not reached, the notice will be issued; the ''list must be specific as to the records that must be kept by the taxpayer but care must be taken not to dictate to the taxpayer how the records are to be kept.''[446]

In both agreed and unagreed situations, the examiner will prepare a TE/GE referral information report (Form 5666); this report will recommend a follow-up examination no less than two years subsequent to the year of the examination. The case will be closed to EO Mandatory Review; that unit will forward the report to EO Classification for a future year audit. Classification will make the determination as to whether a follow-up examination is warranted. At the appropriate time, should EO Classification deem that a follow-up examination or compliance check is necessary, the examiner will, of course, determine whether the organization corrected the inadequacies. If the examiner concludes that the organization is in substantial compliance with the recordkeeping requirements, he or she will follow normal examination procedures with respect to the scope of the examination and report-writing. If the examiner concludes that the organization is not substantially complying

[444] *Id*. §§ 2, 3.
[445] *Id*. § 4.
[446] *Id*. §§ 7–9, 14, 15.

with the requirements to keep adequate records, he or she is to consider additional enforcement measures, such as the assertion of penalties or revocation of tax-exempt status.[447]

§ 5.26 REVOCATION DUE TO INADEQUATE RECORDS OR FAILURE TO PROVIDE REQUESTED INFORMATION

A tax-exempt organization, irrespective of whether it is required to file an annual information return, must submit such information as may be required by the IRS for the purpose of inquiring into its exempt status and administering the law of tax-exempt organizations.[448] An exempt organization is required to supply the IRS with such information as is required by revenue procedures and annual information return instructions, and to keep such books and records as are necessary to substantiate that information.[449] Failure by an otherwise tax-exempt organization to maintain proper books and records, and failure to make them available to the IRS in the context of an examination, may result in revocation of exemption on the ground that the organization ''is not observing the conditions required'' for exempt status. Generally, the IRS will not propose revocation of an organization's exempt status due to its inadequate records unless an inadequate records notice was issued as a result of a prior examination.[450]

The procedures note that a 1959 revenue ruling[451] has never been withdrawn and ''can be used'' to support revocation of an organization's exemption where the organization will not furnish the information necessary to enable the IRS to make a determination as to whether there have been any substantial changes in the organization's character, purpose, or methods of operation, and there is a ''substantial doubt,'' from the standpoint of the IRS, that the organization should continue to be exempt.[452] If an exempt organization continues to fail to substantially comply with the law as to maintenance of adequate books and records, or fails to provide requested information, the examiner is expected to discuss these inadequacies with the group manager to determine whether to propose revocation of the organization's exempt status.[453]

If the IRS decides that revocation of tax exemption of an organization, for one or more of these inadequacies, is appropriate, the agency's workpapers and examination report must demonstrate:

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[447] *Id*. §§ 11, 13, 16, 17, 19.
[448] Reg. § 1.6033-2(1)(2); IRM 4.75.13.5.7.2 § 1.
[449] Reg. §§ 1.6001-1(c), 1.6033-2(a)(1), (2); IRM 4.75.13.5.7.2 § 2.
[450] IRM 4.75.13.5.7.2 § 3.
[451] Rev. Rul. 59-95, 1959-1 C.B. 627 (issued before the enactment of IRC § 6652).
[452] IRM 4.75.13.5.7.2 § 4.
[453] *Id*. § 5.

- How the information requested from the organization is material in establishing the organization's eligibility for ongoing tax-exempt status
- That the organization was accorded an adequate opportunity to provide the requested information
- That the organization was advised of the consequences of failing to provide the information to the IRS

The group manager is to consider requesting advice from area counsel during the development of a revocation issue based on a failure to maintain or provide records to the IRS.[454]

§ 5.27 ISSUES SUBJECT TO DECLARATORY JUDGMENT

When an exemption or public charity/private foundation classification issue is identified during the course of an examination of a tax-exempt charitable organization, the examiner is to determine whether the issue is subject to the declaratory judgment rules.[455] If it is, the examiner is cautioned to ''take care'' to ''share'' all documentation of the issue with the exempt organization because the case may be decided solely on the basis of the administrative record.[456]

§ 5.28 IRS INABILITY TO LOCATE ORGANIZATION

An examiner may find himself or herself in the position of being unable to contact a tax-exempt organization by telephone, with the organization not responding to the initial contact letter. Each instance of this type warrants ''good judgment'' in determining the appropriate steps to take. The following guidelines are to be normally followed by examiners:

- Inspect correspondence in the case file for any change of address.
- Review the case file for possible sources of information that may lead to the entity's ''whereabouts.''
- If the organization is a subordinate entity in a group exemption,[457] contact the central organization to obtain the address of the organization or the names and addresses of its officers.
- Use ChoicePoint to find current names and addresses for the organization and/or its trustees, directors, and/or officers.

[454]*Id*. § 6.
[455]See § 3.13(b).
[456]IRM 4.75.13.5.8 §§ 1, 2.
[457]See App. C § VI B.

- Check telephone directories for the names and addresses for the organization and/or its trustees, directors, and/or officers.
- Check the current address by submitting an IDRS master file information request.
- Contact the Post Office for a current address.
- Check Internet resources.
- If the organization is a corporation, check the state annual corporate registration for the name of the entity's registered agent.
- Contact third parties such as current or former employees or return preparers.[458]

If the organization cannot be located after the examiner has exhausted the above sources of information, the examiner is to send examination letters by certified mail to the organization's last known address and the last known officers. The letters should have a date by which a response is required.[459]

§ 5.29 TECHNICAL ADVISOR ISSUES

The IRS has an Exempt Organization Technical Advisor Program; certain cases and issues warranting ''continuing coordination'' are included in this program. When this program is to be utilized, case/group managers examining cases within an ''industry'' will receive notice from the technical advisor that their case has been included as an ''identified industry case'' at the time the case is assigned. Also, the case/group manager is to advise the technical advisor of any large case that is ''engaged in the business activity of a particular designated industry'' and is not an identified industry case.[460]

Further, EO area managers are encouraged to request technical assistance from EO Rulings and Agreements with respect to ''technical problems,'' and to seek ''clarification and guidance on issues which may or may not arise in an examination of a particular return.''[461]

§ 5.30 SUSPENDED ISSUES

Some case files require ''suspension of action''; these files are normally held in EO Mandatory Review until such time as action on the case can resume. These cases include technical advice cases and what the IRS refers to as *Form 1254 suspense cases* (see below). Prior to forwarding a suspense case

[458]IRM 4.75.13.5.9 §§ 1, 2. Third-party procedures (if applicable) are the subject of Reg. § 301.7602-2. See § 1.8.
[459]IRM 4.75.13.5.9 §§ 3, 4.
[460]IRM 4.75.13.5.10 §§ 1, 5.
[461]*Id*. § 4.

to Mandatory Review, it is the group's responsibility to ensure that the applicable statute of limitations[462] is protected for at least one year. Once the case is in Mandatory Review, it is the reviewer's responsibility to obtain any needed extensions of the statute of limitations. Mandatory Review will secure (or attempt to secure) extensions on subsequent years if necessary.[463]

Cases involving issue(s) having ''nationwide implications'' or those within a particular judicial jurisdiction are, at times, suspended to ensure ''uniform and consistent'' treatment of the issue(s). This suspension includes cases in which the issue is the same or similar to an issue in a case awaiting final action by Rulings and Agreements or the Office of the Chief Counsel (TE/GE). Cases involving issues that have been identified as Form 1254 suspense cases (so called because these cases are forwarded to Mandatory Review by means of IRS Form 1254) are to be sent to EO Mandatory Review. The examiner is expected to have completed the examination with regard to all other issues prior to forwarding the case to Mandatory Review.[464]

§ 5.31 LAW RESEARCH BY EXAMINERS

The procedures state that ''[c]onclusions reached by examiners must reflect correct application of the [statutory] law, regulations, court opinions, revenue rulings, etc.'' Also, examiners must ''correctly determine the meaning of statutory provisions and not adopt strained interpretation[s].'' Noting that the ''Federal tax system is constantly changing,'' the procedures state that examiners ''must keep well informed of the ever-growing body of tax authorities and advances in the management and storage of information.'' The procedures add: ''Income tax law is too complex for examiners to immediately perceive its ramifications and provisions in all examinations.''[465]

Observing that the Internal Revenue Code is ''continually changing,'' the procedures caution examiners to determine the law that is applicable to the year under examination. They are to determine whether the applicable law has been modified and, if so, the date on which the changes became effective.[466]

The procedures contain, primarily for the benefit of examiners, a description of the various tax law authorities, namely, the Internal Revenue Code, congressional committee reports, regulations, the Internal Revenue Bulletin,

[462]See § 3.11.
[463]IRM 4.75.13.5.11.
[464]IRM 4.75.13.5.11.1.
[465]IRM 4.75.13.6.
[466]IRM 4.75.13.6.1.3.

revenue rulings, revenue procedures, other IRS publications, and court opinions, as well as IRS determinations that are not formally *law*, such as private letter rulings and technical advice memoranda.[467]

§ 5.32 CLOSING LETTERS; EXAMINATION REPORTS

The procedures state that reports of examination should contain ''all information necessary to ensure a clear understanding of the examination conclusions and the applicable law upon which they were based.'' Examination reports, unlike workpapers, are ''legally binding documents'' and, when executed, serve as the basis for tax law enforcement action. Examiners are, therefore, exhorted to ''take all necessary steps to ensure [that] examination reports are prepared accurately and completely.''[468]

(a) Terminology

There are a number of situations in which a tax-exempt organization examination case will be closed. The following is a list of how these cases are generally closed:[469]

- *No change*. In some instances, an examination is closed with no resulting change in the organization's tax-exempt status, public charity/private foundation status, and/or tax liability. Also, in these cases, there are no other issues as to which a written advisory is appropriate.
- *No-change with written advisory*. The closing of an exempt organization examination may be on a no-change basis but a written advisory may be deemed by the IRS to be appropriate. The IRS may be of the view that an aspect of an organization's operations, if enlarged or is ongoing, may endanger its exempt status or that there are compliance issues (other than exempt status or tax changes) that should be called to the attention of the organization.
- *Agreed*. An examination may close with the exempt organization agreeing to the IRS's position as to a change in exempt status, public charity status, and/or tax liability, and signing the appropriate waiver and acceptance forms.[470] If the case involves violation of certain excise

[467] IRM 4.75.13.6.1–4.75.13.6.14. The material in these sections of the procedures is incorporated in Appendix A (''Sources of the Law'').
[468] IRM 4.75.15.1 § 2.
[469] As this text is being written (late 2007), the author is in the process of working with the IRS on behalf of a client in closing an exempt organizations audit, where all issues have been resolved in favor of the organization. The IRS agents involved, however, are uncertain as to what the nature of the closing documentation should be. It would seem that the appropriate document would be a no-change closing letter.
[470] Form 4549 or 870-E.

tax rules,[471] correction of all acts or failures to act that gave rise to the tax(es) must be completed before the case can be an agreed case.[472]

- *Partially agreed*. A partially agreed case is one that entails more than one issue, where the exempt organization agrees to at least one issue and disagrees as to at least one issue, and signs the appropriate waiver and acceptance forms as to the agreed issue(s). If the case involves one or more of these excise taxes, there must be the appropriate correction in connection with the agreed issue(s).
- *Excepted agreed*. An excepted agreed case in one where the exempt organization agrees to one or more proposed adjustments but the examination results are subject to IRS review, additional processing, or another condition (such as modification or revocation of exempt status). The exempt organization may waive the statutory restrictions on assessment and collection of the deficiency of a tax by signing a waiver. The signing of the waiver does not preclude assertion of a further deficiency by the IRS or a request for further consideration of the issues by the organization, waives the organization's right to contest the issue(s) in the U.S. Tax Court, and stops the running of interest 30 days from the date of receipt of the signed waiver by the IRS.
- *Unagreed*. An unagreed case is one in which the exempt organization has not signed the appropriate waiver and acceptance forms or has not corrected all acts or failures to act that gave rise to one or more of the foregoing excise taxes.[473]

(b) Examination Report Forms

There are myriad IRS forms that are utilized in connection with examinations of tax-exempt organizations:

- Form 870-E—Waiver of Restrictions on Assessment and Collection of Deficiency and Acceptance of Overassessment
- Form 886-A—Explanation of Items
- Form 2297—Waiver of Statutory Notification of Claim Disallowance
- Form 3363—Acceptance of Proposed Disallowance of Claim for Refund or Credit

[471] Namely, the rules of IRC §§ 4941–4945, 4951 and 4952, 4955, and/or 4958 (see App. C §§ V F, IY, IV, II F).
[472] A case subject to the exempt organizations declaratory judgment procedure (see § 3.13(b)) is treated as an unagreed case (see below).
[473] IRM 4.75.15.2.

- Form 4549—Income Tax Examination Changes (Report and Agreement Form)
- Form 4549-A—Income Tax Examination Changes (Report Form Only)
- Form 4549-B—Income Tax Examination Changes (Adjustment Continuation Sheet for Form 4549 or Form 4549-A)
- Form 4620—Transmittal Letter—Exempt Organizations
- Form 4621—Exempt Organizations—Report of Examination (Proposed Tax Changes)
- Form 4621-A—Exempt Organizations—Report of Examination (Proposed Status Change)
- Form 4883—Exempt Organizations Excise Tax Audit Changes[474]
- Form 6018—Consent to Proposed Action—IRC § 7428[475]
- Form 6018-A—Consent to Proposed Action[476]

§ 5.33 EXAMINATION OUTCOMES

An IRS examination of a tax-exempt organization can have an array of outcomes, ranging from a no-change letter (obviously, the preferable outcome from an exempt organization's viewpoint) to revocation of exemption (obviously, the worst of outcomes from that point of view).

(a) No-Change Examinations

Following an IRS examination of a tax-exempt organization, the examiner may conclude that no change as to the organization's exempt status is necessary. (If an examination is for more than one year, it can evolve into a no-change examination only if all of the years are being ''no-changed.'') When closing the case, the examiner is expected to substantiate his or her conclusions in the requisite IRS documents,[477] including workpapers; the case is to be submitted to the IRS's Examination Support Staff for processing.

The result of an examination of a private foundation can be a no-change examination only when there is no change in exempt status and in private foundation status, and there is no IRC Chapter 42 tax liability. When a foundation manager, self-dealer, or other disqualified person is involved in a no-change examination, each of these persons will receive a no-change letter.[478]

[474]This form pertains to IRC Chapter 41, Chapter 42, and § 170(f)(10)(F) excise taxes.
[475]See § 3.13(b).
[476]IRM 4.75.15.3.
[477]Forms 5772 and 5773.
[478]IRM 4.75.15.4.

(b) No-Change with Written Advisory Examinations

During an examination, the examiner may encounter ''minor issues which, if enlarged, could jeopardize the exempt status of the organization.'' The examiner may issue a no-change-with-advisory letter, providing the ''appropriate narrative addressing the issues revealed'' by the examination. These letters are appropriate in situations such as the following:

- Failure to timely file an annual information return
- Filing an incomplete or inaccurate annual information return
- Failure to timely file one or more tax returns
- Failure to file or to furnish required payer information returns[479]
- Where reasonable cause is not shown, notification that the appropriate IRS campus will assess penalties for failure to file one or more forms concerning independent contractor status[480]
- Failure to file forms concerning gambling winnings[481]
- Failure to withhold applicable federal income tax at the rate of 28 percent for certain gambling winnings over $5,000
- Failure to secure taxpayer identification numbers of payees prior to making payments and resulting backup withholding requirements
- Failure to comply with the requirements regarding notification of nondeductibility of contributions[482]
- Failure to identify special fundraising activities
- Improperly combining income from different sources instead of reporting each source on appropriate lines
- Improper netting of income and expenses on annual information return and tax return reporting unrelated business income[483]
- Failure to report required trustee, director, and/or officer compensation and other data
- Failure to notify the IRS of changes in purpose, character, or method of operation[484]
- Engaging in activities that, if enlarged or ongoing, could jeopardize exempt status

[479]For example, Forms W-2, W-2G, and 1099.
[480]Form 1099.
[481]Forms W-2G and 1099.
[482]See App. C § XIV D.
[483]See *id*. § VII A, C.
[484]See *id*. § VII A.

- Failure to maintain adequate books and records[485]
- Failure by an exempt social club to comply with the nonmember recordkeeping requirements[486]
- Monitoring of compliance by an exempt social club with the limitations guidelines concerning nonmember and investment income[487]
- Where tax changes are made to related returns, or delinquent related returns are obtained,[488] an advisory statement in the letter for the primary return and a separate letter with respect to the related examination(s)
- Changes to income, deduction, or balance sheet items on an annual information return or unrelated business income tax return where there is no change to an organization's tax liability

No-change with written advisory letters is not appropriate in situations where:

- Modification or revocation of tax-exempt status is warranted.
- Modification of public charity/private foundation status is warranted.
- Imposition of or an adjustment to an unrelated business income tax is warranted.
- Imposition of or adjustment to an IRC Chapter 41 or Chapter 42 tax liability is warranted.[489]

(c) Change Cases

In all change cases, the examiner is to provide the tax-exempt organization with a written explanation of the changes as soon as they are fully developed. To this end, the examiner will prepare a summary of issues or a draft of the Revenue Agents Report (RAR).[490] The RAR should include only status change or tax change issues. If compliance issues warranting a written advisory are encountered,[491] in addition to tax change and/or status change issues, the compliance issues are to be addressed in a separate written advisory.[492]

The use of the Explanation of Items form[493] is optional for agreed examination reports inasmuch as the explanation of changes for agreed reports

[485]See *id*. § XII D.
[486]See *id*. § I N.
[487]See *id*.
[488]For example, Forms 990-T, 4720, 940, and 941.
[489]IRM 4.75.15.5.
[490]IRM 4.75.15.6.
[491]See § 5.33(b).
[492]IRM 4.75.15.7 § 1.
[493]Form 886-A.

generally is brief. This form is necessary in agreed reports only when the explanation of changes exceed the space provided on the appropriate exempt organizations examination report form or income tax examination change form.[494] The use of this form is mandatory for unagreed examination reports. It is also mandatory for agreed and unagreed revocation cases.[495]

(d) Presentation of Issues in Examination Reports

In examination cases resulting in proposed changes in a tax-exempt organization's status and/or tax liability, the proposed changes will be presented in a report of examination that includes:

- Transmittal Letter (for unagreed cases only) (Form 4620)
- Exempt Organizations—Report of Examination (Proposed Tax Changes) (Form 4621)
- Exempt Organizations—Report of Examination (Proposed Status Changes) (Form 4621-A)
- Income Tax Examination Changes (Form 4549/4549-A)
- EO Excise Tax Audit Changes[496] (Form 4883)
- Explanation of Items (Form 886-A)[497]

(e) Revocation of Exempt Status

On the basis of an examination of a return or information from other sources,[498] an IRS examiner may conclude that a determination or ruling letter recognizing tax exemption should be revoked. Should revocation occur, it means that the IRS has withdrawn its recognition of exemption for one or more tax years.[499]

When an examiner determines that revocation of an organization's tax-exempt status is appropriate, whether agreed or unagreed, the examiner is to prepare a report of examination proposing the revocation. If the exempt organization is a charitable entity and it agrees to the revocation, the organization may execute an IRS form[500] to memorialize its present intent to not protest the proposed revocation or seek a declaratory judgment regarding it. The execution of this form is not, however, legally binding; thus, it does not waive the organization's right to file a protest or pursue a declaratory judgment in connection with

[494]Forms 4549, 4621, or 4621-A.
[495]IRM 4.75.15.7.
[496]See text accompanied by *supra* note 489.
[497]IRM 4.75.15.8.
[498]See § 5.3(a).
[499]IRM 4.75.15.9 § 1.
[500]Form 6018.

it. Another IRS form[501] is used when the examination concerns another type of exempt organization and the entity agrees with the proposed revocation.[502]

(f) Modification of Exempt Status

On the basis of an examination of a return or information from other sources,[503] an examiner of a tax-exempt organization may conclude that a determination or ruling letter recognizing the exemption needs to be modified. The term *modified*, as used in this context, means that the IRS determines that an organization continues to qualify for exemption but not under the category for which it originally qualified; the agency thus modifies the determination or ruling letter to restate the Internal Revenue Code section that is deemed to be the correct basis for the exemption. This process cannot, however, occur with respect to charitable organizations[504]; if an examiner concludes that an organization no longer qualifies as a charitable organization, its exempt status cannot be modified but must be revoked.[505]

If modification of tax exemption is recommended and the examination is agreed, the examiner is to secure a consent from the organization[506] and prepare a report of examination setting forth the issue(s), facts, law, government's position, and conclusions.[507] When the examination or an organization results in an unagreed proposed modification of exempt status, the examiner is to prepare a report of examination.[508] The examiner is also expected to include with the report of examination a consent form, in case the organization decides to agree with the proposed modification after reviewing the examination report.[509]

(g) Reclassification of Public Charity, Foundation Status

On the basis of an examination of a return or information from other sources,[510] an examiner of a tax-exempt charitable organization may conclude that the public charity/private foundation status of the entity should be reclassified. This type of reclassification occurs when a charitable organization's status is changed among the four categories of public charities,[511] or as to

[501]Form 6018-A.
[502]IRM 4.75.15.9 §§ 2–4. For example, a gated housing development's homeowners' association was advised by the IRS that it was losing its exempt status as a social welfare organization (See App. C, II); the organization, as part of the process of agreeing to this revocation of status, executed Form 6018-A (Private Letter Ruling 200706014 (Nov. 15, 2006)).
[503]See § 5.3(a).
[504]That is, IRC § 501(c)(3) organizations.
[505]IRM 4.75.15.10.
[506]Form 6018-A.
[507]IRM 4.75.15.10.1.
[508]Forms 4620, 4621-A, 886-A.
[509]IRM 4.75.15.10.2.
[510]See § 5.3(a).
[511]See App. C § V B–E.

private nonoperating foundation status[512] or private operating foundation status.[513] When an IRS examiner determines that reclassification of an organization's public charity/private foundation status is appropriate, he or she will prepare a report of examination proposing the reclassification. A charitable organization may execute an IRS form[514] to memorialize its present intent to not protest the proposed reclassification or not seek a declaratory judgment regarding it.[515] This examination report must be an unagreed report because these cases are subject to the declaratory judgment procedure[516] and because they are subject to appeal.[517]

The report of examination for a proposed public charity/private foundation status reclassification issue should contain:

- A statement of issues on which the proposed reclassification is based
- A statement of material facts that are relevant to these issues, including (when applicable) schedules setting forth the applicable public support test computations[518]
- A statement of the applicable law
- A statement of the tax-exempt organization's position on the issues
- A statement of the government's position, including a ''clear explanation of the underlying reasoning regarding the foundation status reclassification''
- A brief statement of the government's proposed conclusion regarding the reclassification
- The proposed effective date of the reclassification
- A statement affirming the organization's ongoing qualification for exempt status[519]

(h) Modification of Operating Foundation Status

If an examination discloses that an organization classified as a private operating foundation[520] is failing to meet one or more tests for operating foundation status, the examiner is expected to propose modification of the organization's status to that of a standard (nonoperating) private foundation.

[512]See *id*. § V F.
[513]See *id*.
[514]Form 6018.
[515]See, however, § 5.33(e), second paragraph.
[516]See § 3.13(b).
[517]IRM 4.75.15.11 §§ 1–3, 5, 6.
[518]See App. C § V C.
[519]IRM 4.75.15.11 § 11.
[520]See App. C § V F.

The organization may execute an IRS form[521] to memorialize its present intent to not protest the proposed foundation status reclassification or seek a declaratory judgment regarding it. The execution of this form, however, is not legally binding on the exempt organization. All foundation status reclassification cases must be treated as unagreed cases.[522]

The examiner will prepare a proposed modification report[523] setting forth the proposal; this report should contain:

- A statement of the issues on which the proposed reclassification is based
- A statement of material facts relevant to the issues, including computations as to the assets test, the endowment test, and the income test
- A statement of the applicable statutory law, tax regulations, and other governing precedent
- A statement of the exempt organization's position on the operating foundation status reclassification issue
- A statement of the government's position in this regard, including a ''clear statement of the underlying reasoning''
- A brief statement of the government's proposed conclusion regarding the foundation status reclassification
- The proposed effective date of the reclassification
- A statement reaffirming the organization's exempt status[524]

(i) Unrelated Business Issues

An examination may result in an adjustment to a tax-exempt organization's unrelated business income tax liability.[525] This type of adjustment will result in the case being agreed, partially agreed, or unagreed. There may be a proposed change in exempt status, in which case an unrelated business income tax adjustment may become an alternative issue.[526]

In a case in which the examination adjustment results in agreed unrelated business income tax changes, the tax-exempt organization will be expected to execute an agreement as to the matter.[527] This agreement may also be used in cases where adjustments to income or deduction items do not affect or warrant a change in tax liability or refundable credits on the return[528] examined. One

[521]Form 6018.
[522]IRM 4.75.15.12 §§ 2, 4, 5.
[523]This entails Forms 4620, 4621, and 886-A.
[524]IRM 4.75.15.12 § 12.
[525]See App. C § IX.
[526]IRM 4.75.15.13 § 2.
[527]Form 4549, which is designed to cover three years; if more than three years were examined, Form 4549-A will be utilized.
[528]Form 990-T. See App. C § VII C.

or more of these adjustments (such as an adjustment to a net operating loss), however, may affect subsequent returns of the exempt organization.[529]

This agreement will be provided to the tax-exempt organization following completion of the examination. The examiner will prepare a written explanation of the adjustments[530] and incorporate it with the agreement; this explanation is to include a statement of the issues, the pertinent facts, applicable law, the exempt organization's and the government's position on the proposed adjustments, and the conclusion(s). This explanation in agreed cases ''can usually be brief, but it must be sufficient to provide a clear understanding of the issues, conclusions reached, and the law on which it is based.''[531]

Unagreed cases are, of course, those involving examinations where the tax-exempt organization does not agree with the proposed changes.[532] In a case involving one or more unrelated business issues, the IRS will prepare an examination report setting forth the proposed adjustment(s). The contents of this report will be the same as in an agreed case, although in all likelihood will be in greater detail.[533]

(j) Private Foundation Excise Taxes

IRS examination of forms filed in the private foundation context[534] may result in one or more adjustments to the excise tax liability of a private foundation, foundation manager, disqualified person, and/or self-dealer.[535] These adjustments will result in agreed, partially agreed, and unagreed cases. In addition, an adjustment of this nature is likely to lead to a correction[536] of an act or failure to act.[537]

In an agreed case involving the excise tax on a private foundation's net investment income, all that need be done from the standpoint of the IRS is to secure a consent agreement executed by the foundation[538] regarding the tax change. A case involving any of the other private foundation excise taxes is an agreed case only where (1) the acts or failures to act giving rise to the tax liability have been corrected and (2) a consent agreement has been executed by the foundation for the tax deficiency.[539] The examiner will solicit the agreement for the amount of one or more of these initial taxes only after each act or failure

[529]IRM 4.75.15.13.1 § 1.
[530]This will be done on Form 886-A.
[531]*Id*. §§ 3, 4.
[532]See § 5.32(a).
[533]IRM 4.75.15.13.2. Also IRM 4.75.15.7, 4.75.8.
[534]Forms 990-PF, 4720.
[535]These taxes are those imposed by IRC §§ 4940–4945. See App. C § V F.
[536]See App. C § V F.
[537]IRM 4.75.15.14.
[538]Form 870-E.
[539]In a situation where a Form 4720 has not been filed, the securing by the IRS of the delinquent Form 4720 reporting the correct tax liability satisfies this requirement.

to act that gave rise to the tax(es) has, as noted, been corrected, although a partial agreement may be solicited in a particular case when correction has been completed and verified with respect to an act or failure to act but not completed with respect to another act or failure to act.[540] The examination report will include a statement of the issues, pertinent facts, applicable law, and conclusions.[541]

In the case of an unagreed private foundation excise tax case, where correction has been completed (and the examiner has verified that fact), the only dispute is about the amount of initial tax liability; the examination report must fully describe the act or failure to act and the steps taken to correct it.[542] By contrast, in a private foundation excise tax case, where correction has not been (or cannot be) completed prior to closing the examination and the initial excise tax liability is unagreed, the examiner will recommend, in the examination report, imposition of the initial excise tax and propose the second-level tax in the event the act or failure to act giving rise to the initial tax is not corrected within the taxable period. As the guidelines state the matter, ''[r]ecommending imposition of both taxes in this manner is essential for the issuance of a proper notice of deficiency'' and it ''brings together all of the issues and alerts the taxpayer to the full consequences of the failure to correct.''[543] Where a foundation has paid the initial excise tax or reported it, but does not agree (or is unable) to correct prior to close of the examination, the examiner will recommend, in the examination report, imposition of the appropriate second-level tax.[544]

(k) Non-Private Foundation Excise Taxes

In addition to the federal excise tax regime applicable in the private foundation context, there are excise taxes that may be imposed on other forms of tax-exempt organizations and disqualified persons and organization managers with respect to them. Some of the violations that occasion these taxes require correction; others do not. These taxes are the following:

- Tax on premiums paid on personal benefit contracts[545]
- Tax on excess lobbying expenditures[546]

[540]For example, an agreed case would be one where a private foundation agrees to the assessment of excise taxes for violation of IRC §§ 4942 and 4945, executes Form 870-E, corrects the violations, and submits delinquent Forms 4720. By contrast, if the facts were the same, except that the foundation corrected only the IRC § 4942 violation, the case would be closed on a partially agreed basis.
[541]IRM 4.75.15.14.1 §§ 1–3.
[542]IRM 4.75.15.14.2 § 1.
[543]*Id*. § 2.
[544]*Id*. § 3.
[545]See App. C § XII E. This tax is reportable on Form 4720.
[546]See App. C § III A. This tax is reportable on Form 4720.

- Tax on disqualifying lobbying expenditures[547]
- Tax on self-dealing involving black lung benefit trusts[548]
- Tax on taxable expenditures involving black lung benefit trusts[549]
- Tax on excess contributions to black lung benefit trusts[550]
- Tax on political expenditures[551]
- Tax on excess benefit transactions[552]

In general, these excise tax change cases are considered agreed cases only if any required correction for the type of violation involved is completed and a waiver[553] is signed agreeing to the tax adjustment. As to the taxes on personal benefit contract premiums, lobbying expenditures, and excess contributions to black lung benefit trusts, there is no correction requirement or second-level tax; accordingly, a case involving one of these taxes, where the only change is to tax liability, is an agreed case where a waiver is executed. Cases involving the other two black lung benefit trusts taxes, the tax on political expenditures, and the tax on excess benefit transactions are considered to be agreed cases only if (1) the acts or failures to act giving rise to the tax liability have been corrected and (2) a consent agreement has been executed. If a form reporting the correct tax liability has not been filed, the IRS would secure this form. The partial agreement rules apply in this context, as do the rules concerning the contents of the examination report.[554]

These excise tax change cases are considered unagreed cases if any required correction for the type of violation involved is not completed or a waiver agreeing to the tax adjustment is not signed. Again, a partial agreement may be solicited in a particular case when correction has been completed and verified with respect to an act or failure to act but not completed with respect to another act or failure to act.[555]

As to the taxes on personal benefit contract premiums, lobbying expenditures, and excess contributions to black lung benefit trusts, there is, as noted, no correction requirement or second-level tax; accordingly, a case involving one of these taxes is an unagreed case where a waiver has not been executed for the proposed tax changes.[556] Cases involving the other two black lung benefit trusts taxes, the tax on political expenditures, and the tax on excess benefit

[547]See App. C § III A. This tax is reportable on Form 4720.
[548]See App. C § I Y. This tax is reportable on Form 990-BL.
[549]See App. C § I Y. This tax is reportable on Form 990-BL.
[550]See App. C § I Y. This tax is reportable on Form 6069.
[551]See App. C § IV A. This tax is reportable on Form 4720.
[552]See App. C § II F. This tax is reportable on Form 4720. IRM 4.75.15.15.
[553]Form 870-E.
[554]IRM 4.75.15.15.1.
[555]IRM 4.75.15.15.2 §§ 1, 2.
[556]*Id*. § 3.

transactions are considered to be unagreed cases where (1) the acts or failures to act giving rise to the tax liability have been corrected, (2) the correction occurred within the taxable period (so there is no second-level tax), and (3) the remaining dispute is over the amount of the initial tax. In this situation, the examination report must fully describe the act or failure to act that gave rise to the tax liability, and the steps that were taken to correct it.[557]

Also, cases involving these other two black lung benefit trusts taxes, the tax on political expenditures, and the tax on excess benefit transactions are considered to be unagreed cases where (1) the tax-exempt organization or other party does not agree (or is unable) to correct prior to the closing of the examination and (2) the initial tax liability remains unagreed. In this instance, the examination report will include an explanation of the adjustments, a recommendation as to imposition of the appropriate initial tax, and a proposed assessment of the second-level tax (in the event there is no timely correction).[558] There is another way where a case involving one of these four taxes is an unagreed case: where the party has paid or reported the initial tax but does not agree (or is unable) to correct the transaction prior to closing the examination; in this situation, the examination report will include a recommendation as to imposition of the second-level tax.[559]

In all unagreed cases involving one of these four taxes, where correction is required but has not been completed, the examiner will be expected to consider imposition of the penalty that is applicable with respect to certain repeated or willful and flagrant tax violations.[560] If the examiner is of the view that this penalty is appropriate, the statement of facts in the examination report should include the facts that provide justification for assertion of the penalty.[561]

A situation may arise where a tax-exempt organizations excise tax liability extends beyond the audit years and into a tax year as to which a return is not yet due. In such a case, the examiner will briefly note this fact on the report[562] and will inform the exempt organization or other party of the requirement to file a return for the following tax year[563] and to pay any tax owing with respect to the act or failure to act remaining uncorrected into that following tax year.[564]

(l) Nonexempt Charitable Trusts Examinations

Nonexempt charitable trusts are required to file annual information returns.[565] Fiduciaries of these trusts are required to file a tax return and

[557] *Id*. § 4.
[558] *Id*. §§ 5, 9.
[559] *Id*. § 6.
[560] IRC § 6684.
[561] IRM 4.75.15.15.2 § 11.
[562] Form 886-A or 4621.
[563] Form 4720.
[564] IRM 4.75.15.2 § 12.
[565] Form 5227. See App. C § VII E.

an information return.[566] When the examination of the tax return of one of these trusts results in no change to the income tax reported, the examiner will prepare an ''individually drafted'' no-change letter that includes a statement to the effect that the examination of the return resulted in no change to the tax liability reported on the return and, accordingly, the return is accepted as filed. A no-change with written advisory letter should be issued in one of these cases when it is determined, as a result of an otherwise no-change examination, that the trust failed to provide the requisite information on an annual information return,[567] filed an incomplete return, failed to fully disclose its various income sources,[568] and/or caused another type of compliance problem that does not result in a tax change but should be called to the organization's attention. These advisory letters are to ''specifically identify the problem areas and possible future effects, if any.''[569]

§ 5.34 CLAIMS

A *claim* pertains to an item of income, loss, deduction, or credit entailing a refund of tax. A claim in the tax-exempt organizations context may be filed by one of three methods: the filing of a claim for refund,[570] an amended return,[571] or any other written request for a tax refund (the latter known as an *informal claim*).[572] When a claim is examined, it may be allowed in full, disallowed in full, allowed in part, or offset by other adjustments.[573]

When an exempt organizations claim for an income or excise tax refund is allowed in full, the examiner will prepare the appropriate examination closing letter, report form(s), and agreement form.[574] An income or excess tax agreement in this setting will provide the date, amount, and tax year(s) of the claim, as well as a brief explanation of the reason for the claim and a specification that the claim has been allowed in full. The taxpayer's signature

[566]Forms 1041, 1041-A. See App. C § VII E.
[567]IRC § 6033. See App. C § VII A.
[568]An offense of this nature would be a combining of dissimilar types of income and reporting the aggregate as a single amount.
[569]IRM 4.75.15.16.
[570]Form 843.
[571]Forms 990-T, 990-PF, 4720, or 1041.
[572]The filing of Form 1139 (''Corporate Application for Tentative Refund from Net Carryover Operating Loss'') is not considered a claim. A verbal request for a tax refund, by telephone or during an interview, does not constitute an informal claim.
[573]IRM 4.75.15.17.
[574]If the agreed case involves an income tax (reported on Form 990-T, 1041, or 1120-POL), the closing letter is Letter 3601; the report form(s) are Forms 886-A, 4549, and 4621; and the agreement form is Form 4549. If the agreed case involves an excise tax (reported on Form 990-PF or 4720), the closing letter is Letter 3601; the report form(s) are Forms 886-A, 4621, and 4883; and the agreement form is Form 870-E.

on the agreement is not necessary for closure of the case, although the examiner is likely to attempt to procure the signature.[575]

When an exempt organizations claim for an income or excise tax refund is disallowed in full or in part, the examiner will likewise prepare the appropriate examination closing letter, report form(s), and agreement form.[576] The examination report will provide the date, amount, and tax years of the claim, and state whether it has been disallowed in full or in part. The reason(s) for a full or partial claim disallowance must be ''clearly explained.'' Moreover, the report must contain statements of the issues, facts, law, taxpayer's position, government's position, and conclusion.[577]

§ 5.35 BASIC IRS EXAMINATION FORMS

There are certain IRS forms the familiarity with which is critical to an understanding of the process of IRS examinations of tax-exempt organizations.

(a) Explanation of Items

The IRS utilizes a form to explain changes made as a consequence of an examination of a tax-exempt organization—the *Explanation of Items*.[578] This form, which is prepared as an attachment to an appropriate report form,[579] is thus a form commonly encountered in connection with an IRS exempt organizations examination.[580]

The Explanation of Items is optional for agreed examination reports; this is because the explanation of changes for agreed reports is, by nature, generally brief or nonexistent. Indeed, this form is necessary only when the explanation of changes exceeds the space provided for explanations on the report form—an unlikely outcome. By contrast, the use of an Explanation of Items is mandatory for unagreed examination reports.

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[575]IRM 4.75.15.17.1.

[576]If the agreed portion of the case involves an income tax, the closing letter is Letter 3602; the report form(s) are Forms 886-A and 4549; and the agreement form(s) are Forms 2297, 3363, and 4549. If the unagreed portion of the case involves an income tax, the closing letter is Letter 3602, the report form(s) are Forms 886-A, 4620, 4621, and 4549; the agreement form(s) are Forms 2297, 3363, and 4549. If the agreed portion of the case involves an excise tax, the closing letter is individually prepared; the report form(s) are Forms 886-A, 4621, and 4883; and the agreement form(s) are Forms 870-E, 2297, and 3363. If the unagreed portion of the case involves an excise tax, the closing letter is individually prepared; the report form(s) are Form 886-A, 4620, 4621, and 4883; and the agreement form(s) are Forms 870-E, 2297, and 3363.

[577]IRM 4.75.15.17.2. Before preparing a report on a tax-exempt organizations claim case, the examiner is expected to have a current transcript of the taxpayer's account to determine if there have been any changes to assessed tax amounts after the return was filed and to determine if the campus has already allowed the claim (IRM 4.75.15.17.3).

[578]Form 886-A.

[579]Forms 4620, 4621, 4549/4549-A, and/or 4883.

[580]IRM Exhibit 4.75.15-2.

The explanation of changes is to be written by the IRS examiner in the following format for each examination change or issue:

- *Issues*. The Explanation of Items should ''clearly and precisely'' state the issues or changes proposed by the examiner following the conduct of the examination. All examination issues, including alternative issues, should be listed. Alternative issues should be identified as such, so that it is clear that the alternative issues will be considered only if the primary issue is not upheld.
- *Facts*. The Explanation of Items should provide a ''detailed explanation'' of the facts on which each examination issue or change is based. These facts must be relevant to both the government's and the taxpayer's position, and stated ''accurately and objectively'' (as opposed to ''opinionated or biased'').
- *Law*. The Explanation of Items should set forth, in a ''clear and concise'' manner, the pertinent law (statutes, regulations, IRS revenue rulings, case law, and the like) irrespective of whether it supports or opposes the government's position. Examiners are cautioned to be certain that cited law is current and admonished to not cite IRS private letter rulings, technical advice memoranda, and/or general counsel or chief counsel memoranda.
- *Taxpayer's position*. The Explanation of Items should state the taxpayer's position in ''narrative form if known,'' including any legal authority that the taxpayer is using as the basis for his, her, or its position. If the taxpayer has provided a written statement of position, the entire statement is to be included in the Explanation of Items if it is ''brief''; otherwise, the statement will be summarized in the explanation, with a copy of it attached to the explanation as an exhibit.
- *Government's position*. The Explanation of Items should ''relate the facts to the cited law through a narrative discussion to support'' the IRS's position. Also, the IRS's rebuttal of the taxpayer's position should be in this section of the explanation.
- *Conclusion*. The Explanation of Items should state, as a conclusion, the position of the IRS on the matter(s) involved in the examination.[581]

(b) Internal Transmittal Letter

The IRS has prepared a form—*internal IRS transmittal letter*—that is used by its examiners of tax-exempt organizations to transmit reports within the

[581] IRM Exhibit 4.75.15-3.

agency.[582] For example, an internal IRS transmittal letter is used to transmit reports about unagreed and partially agreed cases, criminal investigation cases reports, and engineers' reports. The information in or accompanied by these letters is to ''complement,'' not replace or repeat, information in the examination workpapers. An internal IRS transmittal letter ''should include significant information to assist managers, reviewers, and subsequent examiners.''

A copy of an internal IRS transmittal letter and any attachments are not—by definition—to be furnished to the taxpayer.[583] Nonetheless, examiners are requested to avoid ''comments based on hearsay, rumor or gossip; comments of a derogatory nature; or identification of an informant (or other source of confidential information) by name, occupation, or relationship.'' Further, examiners are cautioned to not include information in an internal IRS transmittal letter that was ''never shared with the taxpayer,'' inasmuch as the letter may be seen by an Appeals officer, which would ''create an ex parte communication.''[584]

An internal IRS transmittal letter will likely include the following information: the name and address of the taxpayer, the employer identification number of the tax-exempt organization or Social Security number of the taxpayer in the case of an individual, the number of hours charged to the case by the examiner, the exemption section of the organization, the applicable exempt organizations area office, the form number(s) of the return(s) examined, the tax year(s) examined, the names of related cases covered by examination, the name of the examiner and year(s) covered by any last prior examination, the recommended change(s) based on the examination, the name and title of the individual(s) with whom the examination results were discussed, the name of the representative(s) covered by a power of attorney, an indication as to whether an agreement was secured, a summary of an unagreed issues or changes, a statement regarding managerial involvement if the case is an unagreed one, and whether a closing conference was held in connection with an unagreed case with the group manager.[585]

(c) Report of Examination (Tax Changes)

The IRS utilizes a basic report form for examinations in connection with cases involving agreed and unagreed tax-exempt organizations excise tax changes[586] and unagreed unrelated business income tax changes.[587] This

[582]Form 4620.
[583]The examination guidelines, however, are inconsistent on this point, stating that the letter ''should not be shared with the taxpayer'' and elsewhere stating that the letter is ''not normally furnished to the taxpayer.'' The former is the IRS's practice.
[584]IRM Exhibit 4.75.15-4.
[585]IRM Exhibit 4.75.15-5.
[586]IRC Chapters 41 and 42 and IRC § 170(f)(10)(F). See App. C §§ III A, IV A, V F.
[587]Form 4621. IRM Exhibit 4.75.15-6.

report of examination will include the form number(s) of the return(s) covered by the examination, the applicable exempt organizations area office, the date of the report, the taxpayer's name and address, the name and address of the related exempt organization (in an excise tax case, where the taxpayer is a disqualified person or the like), the employer identification number of the organization or Social Security number of the individual involved, the tax year(s) examined, the name of the examiner, the nature of any agreement secured, the name and title of the individual(s) with whom the proposed tax adjustments were discussed, the date a valid waiver or agreement form for the proposed adjustments was received by the IRS, a summary of the proposed adjustment(s), and certain ''remarks.''

The summary of the proposed adjustment(s) is to reflect the specific provision of the Internal Revenue Code applicable to each adjustment.[588] It should also include the specific IRC provision describing any proposed penalty.[589] As to the remarks, if no change to tax-exempt status is being proposed, the ''remarks'' portion of the tax change report to the exempt organization will state that there is no change to the organization's exempt status and that a separate report regarding exempt status will not be issued. If the case is an agreed tax change case, and if there is sufficient space, the agreed adjustments may be explained in this report; otherwise, the proposed adjustments are to be explained in the Explanation of Items report[590] and the remarks section of the examination report will merely contain a cross-reference to that report. In unagreed tax change cases, the proposed adjustments are always explained in the Explanation of Items report, with a cross-reference thereto in the examination report.[591]

(d) Report of Examination (Status Changes)

The IRS also utilizes a basic report form for examinations in connection with cases involving agreed and unagreed revocations of tax-exempt charitable status, unagreed modifications and revocations of other categories of exempt status, and agreed and unagreed public charity/private foundation status changes.[592] This report of examination will include the form number(s) of the return(s) covered by the examination, the applicable exempt organizations area office, the date of the report, the tax-exempt organization's name and address, the exempt organization's employer identification number, the tax year(s) examined, the examiner's name, whether an agreement was secured (and, if so, the date of it),[593] the name and title of the individual(s) with whom

[588]For example, IRC §§ 4945(a)(1), 4945(b)(1), 511(a)(1). See App. C § V F, IX H.
[589]For example, IRC §§ 6651(a)(1), 6684.
[590]Form 886-A.
[591]IRM Exhibit 4.75.15-7.
[592]Form 4621-A. IRM 4.75.15-8.
[593]Form 6018 or Form 6018-A.

the examination findings were discussed, the current public charity/private foundation classification of the organization (if applicable), and the nature of the proposed status change.

As to the status change, this report will state, if tax exemption is being revoked, the section of the Internal Revenue Code on which the exemption was based. If exemption is being modified, the report will indicate the Code section on which exemption was based and the section that is the basis for the proposed change in status. If applicable, the report will state the basis for a change in the organization's public charity/private foundation status. If the case is an agreed status change case, and if there is sufficient space, the agreed status change may be explained in the remarks section of the report; otherwise, the proposed adjustments will be explained in the Explanation of Items report.[594] If the case is unagreed, or treated as unagreed because it is subject to the declaratory judgment procedure,[595] the results of the explanation will be explained on the Explanation of Items report.[596]

(e) Excise Tax Audit Changes

The IRS utilizes a form to set forth adjustments and the calculation of any resulting tax for agreed and unagreed tax-exempt organizations excise tax changes.[597] This form is used for excise taxes imposed on private foundations or other exempt organizations, as well as the excise taxes that may be imposed on disqualified persons, self-dealers, organization managers, and foundation managers with respect to such exempt organizations.[598]

This report will include the name of the taxpayer, the employer identification number of the tax-exempt organization or the Social Security number of the individual involved, the name of the exempt organization involved (if different from that of the taxpayer), the tax year(s) involved, the section(s) of the Internal Revenue Code referencing the basis for the proposed excise tax adjustment, a description of the adjustment, the total amount of adjustment(s) for each tax year, the total amount of adjustments (which may be adjusted pursuant to a prior report), the applicable tax rate percent for the type of excise tax being adjusted, the initial tax liability as previously reported (or as previously adjusted), the initial tax liability (as corrected), the amount of second-level excise tax liability to be proposed (if any), the Code references as to any penalties, and an explanation of adjustments. As to this last item, if the case is unagreed or if the explanation is too lengthy, the explanation should be entered on the Explanation of Items form.[599]

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[594]Form 886-A.
[595]See § 3.13(b).
[596]IRM Exhibit 4.75.15-9.
[597]Form 4883.
[598]IRM 4.75.15-10. This form is not used with respect to gaming excise taxes (see IRM 4.24.5).
[599]IRM Exhibit 4.75.15-11.

CHAPTER SIX

Church Tax Audit Procedures

Special statutory rules apply to IRS inquiries and examinations of churches and conventions and associations of churches.[1] For these purposes, the term *church* includes any organization claiming to be a church and any convention or

[1]IRC § 7611. This section of the Internal Revenue Code is not accompanied by conventional tax regulations. The section is, however, the subject of ''questions and answers relating to church tax inquiries and examinations'' (Reg. § 301.7611-1) (''Church Audit Procedures Q&A'').

A court characterized the IRS church audit rules as follows: Although ''the IRS has broad authority with respect to tax inquiries,'' Congress ''has scaled back these powers with respect to church tax inquiries''; also, this body of law ''provides certain procedural protections to insure that the IRS does not embark on an impermissibly intrusive inquiry into church affairs'' (*United States v. Church of Scientology of Boston, Inc.*, 739 F. Supp. 46, 47 (D. Mass. 1990), *aff'd*, 933 F.2d 1074 (1st Cir. 1991)). Another court wrote that this body of law was enacted to ''add protections for churches from possibly unfounded or overly intrusive tax examinations'' (*United States v. Church of Scientology Western United States*, 973 F.2d 715, 720 (9th Cir. 1992)). This court also observed that the church audit law ''affords churches special protections in the audit context'' (*United States v. C.E. Hobbs Found. for Religious Training & Education, Inc.*, 93-2 U.S.T.C. ¶ 50,588 (9th Cir. 1993).

association of churches,[2] but this term does not include separately incorporated church-supported schools or other organizations that are entities separate from a church.[3]

As the IRS frames the matter, its examinations of churches are subject to these procedures because (aside from the requirements of the statutory law) of the rights guaranteed by the First Amendment to the United States Constitution.[4] The IRS observed that, in carrying out its obligation to enforce the tax laws applicable to churches and ''organizations claiming to be churches,'' its personnel ''must be aware of the sensitive nature of the church-state relationship and observe the restrictions on examinations of churches.''[5]

§ 6.1 CONSTITUTIONAL LAW BACKGROUND

The First Amendment prohibits the government from restricting the free exercise of religion. The courts have interpreted the First Amendment as providing for an absolute freedom of religious belief.[6] The IRS is thus of the view that its personnel engaged in church tax inquiries or examinations ''may not question or evaluate the content of a religious belief.''[7] The agency observed, nonetheless, that ''actions undertaken as a result of religious beliefs are subject to government regulation, including taxation, when such actions implicate a compelling government interest.''[8] The agency added that government regulation of religiously motivated conduct, however, is ''restricted to the extent necessary to enforce that interest.''[9] The IRS continued: ''Religiously motivated

[2]IRC § 7611(h)(1). As to the meaning of the term *church*, see *Tax-Exempt Organizations* § 10.3; as to the meaning of *convention or association of churches*, see *id*. § 10.4. IRS examiners may not disregard an organization's claim to church status unless information in the examiner's possession establishes the claim to be frivolous, in which case the examiner must obtain Counsel's opinion to proceed (IRM 4.76.7.2 § 5). Throughout this chapter, reference to the term *church* includes a *convention or association of churches*.

[3]H. Rep. No. 861, 98th Cong., 2nd Sess. 1102 (1984); Church Audit Procedures Q&A 3. These rules superseded restrictions on audits of churches for unrelated business income purposes (see § 6.8; *infra* note 122).

[4]IRM 4.76. 7.1 § 1.

[5]*Id*. As discussed *infra*, however, the current practice of the IRS often is to slip past what a court termed these ''procedural protections'' (*United States v. Church of Scientology of Boston, Inc*., 739 F. Supp. 46, 47 (D. Mass. 1990), *aff'd*, 933 F.2d 1074 (1st Cir. 1991)) and embark on what amounts to conventional audits (i.e., those undertaken with respect to tax-exempt organizations in general) of what this same court termed ''church affairs'' (*id*., 739 F. Supp. at 47) (see § 6.6(b)).

[6]See *Tax-Exempt Organizations* § 10.1.

[7]IRM 4.76 § 7.1 § 2. The author is aware of two instances, however, where IRS employees were motivated to embark on a church examination because of a personal view that the organization involved was not engaged in sufficiently religious activities.

[8]IRM 4.76.7.1 § 2.

[9]*Id*.

conduct that violates Federal, State or local law may be restricted or prohibited entirely.''[10]

§ 6.2 STATUTORY LAW BACKGROUND

These special rules that are designed to restrict the extent and manner of IRS contacts to determine qualification for tax-exempt status or liability for a tax of an organization that claims to be a church were added to the Internal Revenue Code in 1984. By enacting these rules, Congress intended, according to the IRS, to expand the protection provided by prior law[11] and to minimize IRS contacts with churches to only those necessary to ensure compliance with the tax laws.[12]

Congress's actions concerning church tax inquiries and examinations were, according to the IRS, motivated by two competing considerations. One, Congress was aware of the special problems, including problems of separation of church and state, and the special relationship of a church to its members, that arise when the IRS (or any government agency) examines the records of a church. These problems could be compounded by the relative inexperience of churches in dealing with the IRS and the resulting occasional misunderstandings between churches and the IRS. Although prior law imposed limitations on the examination of church records, these limitations were vague and relied heavily on internal IRS procedures to protect the rights of a church in the examination process. Additionally, there was some uncertainty regarding the scope of the investigations to which prior law applied and the nature of the records protected by the law.[13]

The IRS observed that, ''[w]hile desiring to protect churches from undue interference by the IRS,'' Congress, in enacting the special rules, ''recognized that an increasing number of taxpayers had used the church form primarily as a tax-avoidance device.''[14] The agency added: ''Congress believed that the IRS must retain an unhindered ability to pursue individuals who use the church form in this manner.''[15] The IRS wrote that this body of law ''attempts to resolve these competing considerations by providing detailed rules that the IRS is to follow in making tax inquiries to churches, both as to tax-exempt status and as to the existence of unrelated business income.''[16] These provisions ''emphasize the need for a speedy determination of church tax liabilities and, where possible, a determination, without unnecessary examination of

[10] *Id.*
[11] Prior IRC § 7605(c).
[12] IRM 4.76.7.1 § 3.
[13] *Id.*
[14] IRM 4.76.7.1 § 4.
[15] *Id.*
[16] *Id.*

church books and records.''[17] The IRS wrote that Congress believed that these provisions would ''protect the rights of legitimate churches without unduly hindering IRS efforts to eliminate tax-avoidance schemes posing as religious organizations'' and that the ''adoption of detailed statutory rules would reduce misunderstandings between churches and the IRS and allow for a more stable and cooperative examination process.''[18]

§ 6.3 STATUTORY LAW OVERVIEW

This body of statutory law is captioned ''Restrictions on Church Tax Inquiries and Examinations.''[19] Thus, of course, this law pertains to two types of IRS procedures: *church tax inquiries* and *church tax examinations*. These procedures may be generically referred to as *church audit procedures*. (As noted, for these purposes, the term *church* includes a *convention or association of churches*.[20])

A *church tax inquiry* is any inquiry by the IRS to a church (other than certain requests and inquiries, and a *church tax examination*[21]) that serves as a basis for determining whether a church qualifies for tax exemption by reason of its status as a church,[22] is carrying on one or more unrelated trades or businesses,[23] or otherwise is engaged in activities that may be subject to federal taxation.[24] The term *church tax examination* means any examination, for purposes of making one or more of the three determinations described in the definition of *church tax inquiry*, of church records at the request of the IRS or the religious activities of any church.[25]

The IRS may commence a church tax inquiry only when the agency has satisfied certain *reasonable belief requirements* and certain *notice requirements*.[26] A court observed that ''[t]hese [two] procedural requirements are the heart of the statute, in that they afford religious institutions extensive safeguards from having to defend an audit at all.''[27] The IRS may commence a church tax examination only where certain notice and conference opportunity requirements

[17] *Id*.
[18] *Id*.
[19] IRC § 7611.
[20] See text accompanied by *supra* note 2.
[21] See § 6.7.
[22] Technically, the statute is somewhat incorrect on this point, in that tax exemption is provided for *religious* organizations (IRC § 501(c)(3)); not all religious organizations are churches (see *Tax-Exempt Organizations*, Chapter 10). In some ways, church status is a form of public charity status (*id*. § 12.3(a)). Nonetheless, if an organization is in fact a church, it will be tax-exempt for that reason.
[23] See *Tax-Exempt Organizations*, Chapter 24.
[24] IRC § 7611(h)(2); Church Tax Procedures Q&A 2; IRM 4.76.7.4 § 1.
[25] IRC § 7611(h)(3).
[26] IRC § 7611(a)(1).
[27] *United States v. C.E. Hobbs Found. for Religious Training & Education, Inc.*, 93-2 U.S.T.C. ¶ 50,588 (9th Cir. 1993).

are met; even then, the examination may proceed only (1) in the case of church records,[28] to the extent necessary to determine the liability for, and the amount of, any federal tax, and (2) in the case of religious activities, to the extent necessary to determine whether an organization claiming to be a church is a church for any period.[29]

In general, the IRS must complete a church tax inquiry or church tax examination (and make a final determination as to either or both) within a two-year period beginning on the date the examination notice was issued.[30] Also, in general, in the case of a church tax inquiry as to which there is no examination notice, the IRS must complete the inquiry (and make a final determination with respect to it) within a 90-day period beginning on the date the inquiry notice was issued.[31] The running of these two periods may be suspended under certain circumstances.[32]

There are limitations on the ability of the IRS to revoke the tax-exempt status of a church and on the agency's ability to send a notice of deficiency of a tax involved in a church tax examination or otherwise assess a tax underpayment in connection with a church tax examination.[33] Statutes of limitation apply in connection with exempt status revocations and unrelated business income tax assessments and collections.[34] A proceeding to compel compliance with a summons issued in connection with a church tax inquiry or examination may be stayed under certain circumstances.[35] Limitations are imposed on the ability of the IRS to conduct subsequent inquiries and/or examinations of a church.[36]

§ 6.4 INAPPLICABILITY OF CHURCH AUDIT PROCEDURES

The church audit procedures are inapplicable to any criminal investigation, any inquiry or examination relating to the tax liability of any person other than a church, any income tax termination assessment[37] or jeopardy assessment,[38] any termination assessment in the case of flagrant political expenditures by a charitable organization,[39] any willful attempt to defeat or evade tax, or any knowing failure to file a tax return.[40]

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[28]See § 6.5.
[29]IRC § 7611(b)(1).
[30]IRC § 7611(c)(1)(A).
[31]IRC § 7611(c)(1)(B).
[32]IRC § 7611(c)(2).
[33]IRC § 7611(d)(1).
[34]IRC § 7611(d)(2).
[35]IRC § 7611(e).
[36]IRC § 7611(f).
[37]IRC § 6851.
[38]IRC § 6861.
[39]IRC § 6852. See *Tax-Exempt Organizations* § 23.3.
[40]IRC § 7611(i); Church Audit Procedures Q&A 6.

Inquiries or examinations ''which relate primarily to the tax status or liability of persons other than the church (including the tax status or liability of a contributor or contributors to the church), rather than the tax status or liability of the church itself, will not be subject to the church audit procedures''; these inquiries or examinations may include those regarding the ''inurement of church funds to a particular individual or to another organization, which may result in the denial of all or part of such individual's or organization's deduction for charitable contributions to the church,'' the ''assignment of income or services or excessive contributions to a church,'' or a ''vow of poverty by an individual or individuals followed by a transfer of property or an assignment of income or services to the church.''[41] The IRS ''may inquire of a church regarding these matters without being considered to have commenced a church tax inquiry and may proceed to examine church records relating to these issues (including enforcement of a summons for access to such records) without following the requirements applicable to church tax examinations, subject to the general rules regarding examinations of taxpayer books and records.''[42]

The IRS expanded on the foregoing points. That is, inquiries or examinations that are outside the scope of the church audit procedures ''will be limited to the determination of facts and circumstances specifically relating to the tax liabilities of the individuals or other organizations in question.''[43] For example, in a case against an individual or other organization, ''information may be requested or church records examined, if pertinent, regarding amounts of money, property, or services transferred to the individual or individuals in question (including, but not limited to wages, loans, or non-contractual transfers), the use of church funds for personal expenses, or other similar matters, without having to follow the church tax inquiry and examination procedures.''[44] As an illustration, ''in an assignment of income case against an individual or other organization, information could be requested or church records examined if relevant to an individual's assignment of particular income, donation of property, or transfer of a business to a church.''[45] Nonetheless, without following the church audit procedures, ''no examination of a contributor or membership list in the possession of the church will be made . . . , for the purpose of determining the overall financial structure of the church, merely because such structure was relevant to the church's qualification as a tax-exempt entity and therefore indirectly relevant to the validity of contributors' deductions in general.''[46]

[41]H. Rep. No. 861, 98th Cong., 2nd Sess. 1111 (1984).
[42]*Id*. at 1111–1112. Also Church Audit Procedures Q&A 6.
[43]Church Audit Procedures Q&A 7.
[44]*Id*.
[45]*Id*.
[46]*Id*.

Inquiries or examinations ''conducted outside the church audit procedures will be limited to the determination of facts and circumstances specifically relating to the tax liabilities of the individuals or other organizations in question'' and the IRS may not ''make use of inquiries or examinations regarding individuals' or other organizations' tax liabilities to avoid the intended purpose of the church audit procedures.''[47] However, a ''failure of a church to respond to repeated inquiries regarding individuals' or other organizations' tax liabilities will be considered [by the IRS to be] a reasonable basis for commencement of a church tax inquiry.''[48]

''[R]outine IRS inquiries to a church will not be considered to commence a church tax inquiry and therefore will not trigger application of the church audit procedures.''[49] Nonetheless, ''[r]epeated failure by a church or its agents to reply to such routine inquiries will be considered a reasonable basis for commencement of a church tax inquiry under the applicable church audit procedures.''[50] Also, the IRS may ''request a church to provide information necessary to locate third-party records (for example, bank records), including information regarding the church's chartered name, state and year of incorporation, and location of checking and savings accounts, without following the church audit procedures; failure to provide this type of information is to be a factor, but not a conclusive factor, in determining if there is reasonable cause for commencing a church tax inquiry.''[51] For this purpose, a failure to respond to a request means either that no response has been made or that the response does not make a reasonable attempt to submit the information called for by the specific language of the request.[52]

As stated, the church audit procedures do not apply to any case involving a knowing failure to file a return or a willful attempt to defeat or evade tax. ''[N]othing in the church audit procedures will inhibit IRS inquiries, examinations, or criminal investigations of tax protestor or other tax avoidance schemes posing as religious organizations, including (but not limited to) tax

[47]H. Rep. No. 861, 98th Cong., 2nd Sess. 1112 (1984).

[48]*Id*. Church Audit Procedures Q&A 7.

[49]*Id*. ''Routine questions [for this purpose] include (but are not limited to) questions regarding (1) the filing or failure to file any tax return or information return by the church, (2) compliance with income tax or FICA [Social Security] tax withholding responsibilities by the church, (3) any supplemental information needed to complete the mechanical processing of any incomplete or incorrect return filed by the church, (4) information necessary to process applications for [recognition of] exempt status, letter ruling requests, or employment tax exemption requests by the church, and information identifying a church that is used by the IRS to update its Cumulative List of Charitable Organizations (Pub. 78) and other computer files, and (5) confirmation that a specific business is or is not owned or operated by a church'' (*id*.); Church Audit Procedures Q&A 4. Also, routine requests for this purpose include information necessary to process and update periodically a church's registrations for tax-free transactions (excise tax) and elections for exemption from windfall profit tax (Church Audit Procedures Q&A 4).

[50]*Id*.

[51]*Id*. Also Church Audit Procedures Q&A 5, 7.

[52]Church Audit Procedures Q&A 7.

avoidance schemes posing as mail-order ministries or storefront churches, whether such schemes are limited to one particular taxpayer or encompass a group of taxpayers.''[53]

§ 6.5 CHURCH RECORDS

In general, the term *church records* means all corporate and financial records regularly kept by a church, including corporate minute books and lists of members and contributors.[54] This term does not include records acquired pursuant to a third-party summons[55] or from a governmental agency.[56]

All regularly kept church corporate and financial records, including corporate minute books, contributor lists, and membership lists, constitute church records.[57] The term *church records* also includes any materials that qualify as church books of account.[58] The term further includes ''private correspondence between a church and its members that is in the possession of the church'' but does ''not include records previously filed with a public official or . . . newspapers or newsletters distributed generally to the church members.''[59] Records held by third-party recordkeepers, such as canceled checks or other records in the possession of a bank, are not church records; thus, the IRS is permitted access to these records without regard to the church audit procedures. Pursuant to general law, either the IRS or a third-party recordkeeper generally is required to inform a church of any IRS requests for materials.[60]

The IRS may not determine that a church is not entitled to tax exemption or assess tax for unrelated business income against a church solely on the basis of third-party records, without complying with the church audit procedures. (This rule does not apply to assessments of tax other than for unrelated business income, such as for Social Security or other employment taxes.) The IRS may not use information obtained from bank records to avoid the purposes of the church audit procedures.[61] The IRS may examine the religious activities of an organization claiming to be a church only to the extent necessary to determine if the organization actually is a church for any period.[62]

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[53]*Id*. at 1113. Also IRM 4.76.7.3.
[54]IRC § 7611(h)(4)(A).
[55]IRC § 7609.
[56]IRC § 7611(h)(4)(B).
[57]IRC § 7611(h)(4).
[58]IRC § 7605(c) (as in effect on December 31, 1984). Church Audit Procedures Q&A 14.
[59]H. Rep. No. 861, 98th Cong., 2nd Sess. 1106 (1984).
[60]*Id*. Also Church Audit Procedures Q&A 5.
[61]*Id*. Also Church Audit Procedures Q&A 5.
[62]IRC § 7611(b)(1)(B).

§ 6.6 CHURCH TAX INQUIRIES

A church tax inquiry is considered to commence by the IRS only where an appropriate high-level Treasury official[63] reasonably believes, on the basis of facts and circumstances recorded in writing, that the organization may not qualify for tax exemption as a church, may be carrying on an unrelated trade or business, or otherwise may be engaged in nonexempt activities.[64] Information received by the IRS at its request may not be used to form the basis of a reasonable belief to begin a church tax inquiry, unless the agency's request is made pursuant to the church audit procedures or is a request to which the procedures do not apply.[65]

(a) Reasonable Belief Standard

This *reasonable belief* standard is not a demanding one; as one court stated the matter, ''it is clear from the statute that information relied on by the IRS in initiating a valid inquiry need provide the IRS with nothing more than a reasonable belief that an investigation is warranted.''[66] A church tax inquiry commences when the IRS requests information or materials from a church of a type contained in church records[67] (other than routine requests for information or inquiries regarding matters that do not primarily concern the tax status or liability of the church).[68]

(b) Written Notice to Church

Also, prior to commencement of a church tax inquiry, the IRS must provide written notice to the church of the beginning of the inquiry.[69] This notice must include (1) an explanation of the concerns that gave rise to the inquiry and the general subject matter of the inquiry, and (2) a general explanation of

[63] An *appropriate high-level Treasury official* means the Secretary of the Treasury or any delegate of the Secretary whose rank is no lower than that of a principal IRS officer for an internal revenue region (IRC § 7611(h)(7)). The Church Audit Procedures Q&A 1 references the ''appropriate Regional Commissioner (or higher Treasury official).'' These officials are group managers, EO Examinations (IRS Delegation Order N0. 7-3 (Nov. 16, 2007)); cf. IRM 4.76.7.4.1 § 1 (official is Director, EO Examinations).

[64] IRC § 7611(a)(1)(A), (2).

[65] Church Audit Procedures Q&A 1.

[66] *United States v. C.E. Hobbs Found. for Religious Training & Education, Inc.*, 93-2 U.S.T.C. ¶ 50,588 (9th Cir. 1993), *rev'g* 91-2 U.S.T.C. ¶ 50,444 (E.D. Wash. 1991), where the district court expressed its view that the IRS lacked adequate ''evidence'' to prove that the agency was conducting a valid inquiry, presumably because the court believed that the evidence was not sufficiently probative. The evidence involved consisted of facts adduced as the result of criminal investigations and newspaper articles.

[67] See § 6.5.

[68] Church Audit Procedures Q&A 2; IRM 4.76.7.4.1.

[69] IRC § 7611(a)(1)(B), (3)(A). This notice is referred to throughout the Church Audit Procedures summary as the *first notice* (e.g., Church Audit Procedures Q&A 9). As to IRS processing of the church tax inquiry notice, see IRM 4.76.7.4.5. As to counsel preissuance review, see IRM 4.76.7.4.5.1.

the provisions of the Internal Revenue Code that authorize the inquiry or that may otherwise be involved in the inquiry, and (3) a general explanation of applicable administrative and constitutional law provisions with respect to the inquiry (including the right to a conference with the IRS before any examination of church records is commenced).[70] This inquiry notice ''will generally request information in an effort to alleviate the concerns which gave rise to the inquiry.''[71]

This explanation of the concerns and general subject matter of the inquiry must be ''sufficiently specific to allow the church to understand the particular area of church activities or behavior which is at issue in the inquiry.''[72] For example, as to an inquiry concerning tax-exempt status, the notice should indicate the general aspects of the church's operations or activities that have given rise to questions regarding its exempt status; as to an inquiry regarding an ostensible unrelated business activity, the notice should indicate the general activities of the church that may result in unrelated business income.[73] The IRS, however, ''is not to be precluded from expanding its inquiry beyond the concerns expressed in the notice as a result of facts and circumstances which subsequently come to its attention (including, where appropriate, an expansion of an unrelated income inquiry to include questions of tax-exempt status, or vice-versa).''[74]

This notice requirement does not require the IRS to share particular items of evidence with a church or to identify its sources of information regarding church activities, where provision of the information would be damaging to the inquiry or as to the sources of IRS information.[75] The facts and circumstances that form the basis for a reasonable belief under these rules must be derived from information lawfully obtained by the IRS; information obtained from informants used by the IRS for this purpose must not be known to be unreliable.[76] For example, in connection with an inquiry pertaining to unrelated business activity, the IRS ''might state that its inquiry was prompted by a local newspaper advertisement regarding a church-owned business.''[77] The IRS is not required to reveal the existence or identity of any informers within a church, including present or former employees.[78]

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[70]IRC § 7611(a)(1)(B), (3)(B). Church Audit Procedures Q&A 9. It may be noted, for what it is worth, that the statute differentiates between an *explanation* and a *general explanation*.
[71]Church Audit Procedures Q&A 9.
[72]H. Rep. No. 861, 98th Cong., 2nd Sess. 1102 (1984).
[73]*Id*.
[74]*Id*. In current practice, the IRS, having launched a church tax inquiry, is rarely reluctant to expand the scope of the inquiry, by raising additional issues.
[75]H. Rep. No. 861, 98th Cong., 2nd Sess. 1101 (1984).
[76]*Id*. In practice, the IRS is not particularly discerning about the reliability of the information it uses in support of these inquiries, often relying solely on complaints filed by individuals taking issue with the religious stance or policies of the organization involved and/or on media reports.
[77]Church Audit Procedures Q&A 9.
[78]*Id*.

The general explanation of applicable administrative and constitutional provisions ''should make reference to the various stages of the church audit procedures . . . (including the right to a preexamination conference) and the principle of separation of church and state under the First Amendment,'' although the explanation is ''not required to explain the possible legal or constitutional ramifications of any particular church audit.''[79]

The church tax inquiry notice, formulated as a letter, will open with the following two paragraphs:

> The Internal Revenue Service is responsible for administering the Internal Revenue laws of the United States, including those that apply to organizations exempt from federal income tax. To carry out that responsibility, section 7602 of the Internal Revenue Code (IRC) authorizes the Service to determine the correctness of any tax return, to make a return when none has been filed, and to determine the tax liability of any person or organization. However, IRC section 7611 imposes restrictions on the Service in conducting tax inquiries and examinations of churches and conventions or associations of churches.
>
> In passing IRC section 7611, Congress intended to ensure that the Internal Revenue Service carry out its obligation to resolve questions concerning the tax liability, if any, and the tax-exempt status of churches and organizations claiming to be churches, with due regard for both the rights of church organizations and the responsibility of the Service to enforce the Internal Revenue laws.

The church tax inquiry notice will be signed by the Director, Exempt Organizations Examinations. This notice will be accompanied by at least two enclosures: (1) one or more questions posed by the IRS pertaining to the reason for launching the inquiry and (2) the IRS's formal statement of administrative and constitutional rights.[80]

§ 6.7 CHURCH TAX EXAMINATIONS

The IRS may commence a church tax examination only (1) in the case of church records,[81] to the extent necessary to determine the liability for, and the amount of, any federal tax, and (2) in the case of religious activities, to the extent necessary to determine whether an organization claiming to be a church is a church for any period.[82] Also, this type of examination may be made only if, at least 15 days before the beginning of the examination, the agency provides appropriate written notice[83] to the church and to the appropriate

[79]H. Rep. No. 861, 98th Cong., 2nd Sess. 1101 (1984).
[80]IRM 4.76.7.4.4, 4.76.7.4.5.
[81]See § 6.5.
[82]IRC § 7611(b)(1).
[83]See text accompanied by *infra* note 89. This notice is referred to throughout the Church Audit Procedures summary as the *second notice* (e.g., Church Audit Procedures Q&A 10). As to IRS preparation of this notice, see IRM 4.76.7.5.1. As to preissuance review by counsel, see IRM 4.76.7.5.2.

regional counsel of the IRS and the church has a reasonable time to participate in a conference[84] but only if the church requests the conference before the beginning of the examination.[85]

(a) Notice of Examination

This notice of examination must be in writing and include a copy of the church tax inquiry notice previously provided to the church, a description of the church records and activities that the IRS seeks to examine, an offer to have a conference between the church and the IRS in order to discuss and attempt to resolve concerns relating to the examination, and a copy of all documents that were collected or prepared by the agency for use in the examination and that are required to be disclosed pursuant to the Freedom of Information Act.[86] The documents that must be supplied under this requirement are ''limited to documents specifically concerning the church whose records are to be examined and will not include documents relating to other inquiries or examinations or to IRS practices and procedures in general.''[87] This type of disclosure to a church is ''subject to the restrictions of present law regarding the disclosure of the existence or identity of informers.''[88] The description of materials to be examined in the notice of examination and the documents disclosed by the IRS to the church do not restrict the ability of the IRS to examine the church records or religious activities that are properly within the scope of the examination.[89]

An examination will not begin until 15 days after the mailing of the notice of examination.[90] The church may request a conference at any time prior to beginning of the examination.[91] If the church requests a conference, the IRS is required to schedule the meeting within a reasonable time and may proceed to examine church records only following that meeting.[92] The holding of one meeting with the church is ''sufficient to satisfy the requirement'' and churches cannot utilize this requirement ''in order to unreasonably delay an examination.''[93] The purpose of this meeting between a church and the IRS is to discuss the relevant issues that may arise as part of the inquiry, in an effort to resolve the issues of tax exemption or liability without the necessity of an examination of church records. The church and the IRS are

[84]See text accompanied by *infra* notes 90–94.
[85]IRC §§ 7611(b)(1), (2).
[86]IRC § 7611(b)(3)(A). As to the Freedom of Information Act, see § 4.11.
[87]H. Rep. No. 861, 98th Cong., 2nd Sess. 1103–1104 (1984).
[88]*Id*. at 1104.
[89]IRM 4.76.7.5.
[90]Church Audit Procedures Q&A 10; IRM 4.76.7.5.3.
[91]IRM 4.76.7.5.4.
[92]IRC §§ 7611(b)(2), (3)(A)(iii).
[93]H. Rep. No. 861, 98th Cong., 2nd Sess. 1104 (1984).

expected to ''make a reasonable effort to resolve outstanding issues at the meeting''[94] and the IRS is expected to ''remind the church, at the meeting, in general terms, of the stages of the church audit procedures and the church's rights under such procedures,''[95] although the IRS is not required to ''reveal information at the meeting of a type properly excludable from a written notice (including information regarding the identity of third-party witnesses or evidence provided by such witnesses).''[96]

The notice of examination may be provided by the IRS to a church not less than 15 days after the date on which the church tax inquiry notice was provided to the church.[97] Thus, at least 30 days must pass between the provision by the IRS of the first notice (the church tax inquiry notice) and an examination of church records.[98] For example, if notice of commencement of an inquiry is mailed to a church on March 1, the notice of proposed examination may be mailed to the church no earlier than the 15th day after the date of the inquiry notice, or March 16; if the notice of examination was mailed on March 16, no examination of church records may be made prior to day 30, so the earliest date the examination may commence is March 31.[99] If a church does not request a conference prior to the 30th day, the IRS may proceed to examine church records and complete its investigation or make a determination based on the information already in its possession.

At the time the notice of an examination is provided to a church, the IRS is required to provide a copy of this notice to the appropriate IRS regional counsel. The regional counsel is then allowed 15 days from issuance of the notice in which to file, with the appropriate regional commissioner, an advisory objection to the examination.[100] This regional commissioner is expected to ''take any objection by the regional counsel into account when determining whether to proceed with the examination.''[101]

(b) Scope of Examination

Within the course of a church tax examination that (at the time the examination begins) meets the statutory requirements,[102] the IRS may examine any

[94]In the author's experience, this often does not occur.
[95]In the author's experience, this step is frequently overlooked.
[96]H. Rep. No. 861, 98th Cong., 2nd Sess. 1104 (1984). In general, Church Audit Procedures Q&A 10.
[97]IRC § 7611(b)(3)(B).
[98]This is because a church tax examination may not begin until 15 days after the sending of the notice of examination. See text accompanied by *supra* note 89.
[99]Church Audit Procedures Q&A 12.
[100]IRC § 7611(b)(3)(C). This is concurrent with the 15-day period during which an examination of church records is prohibited pending a request for a conference (see text accompanied by *supra* notes 83–84) (Church Audit Procedures Q&A 10).
[101]H. Rep. No. 861, 98th Cong., 2nd Sess. 1105 (1984).
[102]See § 6.3.

church records or religious activities that were not specified in the examination notice to the extent that examination meets the general prerequisites for launching a church tax examination[103] or, for that matter, the IRS's general examination procedures.[104] The IRS is ''not precluded from expanding its inquiry beyond the concerns expressed in the examination notice (second notice) as a result of facts and circumstances which subsequently come to its attention (including, where appropriate, an expansion of an unrelated business income examination to include questions of tax-exempt status, and vice versa.''[105]

If the matters of concern that gave rise to the issuance of the examination notice are resolved at the conference, the IRS may determine that an examination is not necessary. By contrast, if the matters of concern to the IRS are not resolved at the conference, or if the church does not request a conference, the examination will ordinarily begin.[106]

The IRS may examine church records only to the extent necessary to determine the liability for, and the amount of, any federal tax.[107] This may include examinations to determine the initial or ongoing qualification of the organization as a tax-exempt entity,[108] to determine whether the organization is eligible to receive tax-deductible contributions, or to determine the amount of any tax to be imposed on the organization.[109]

(c) Examination Outcomes

A church tax examination can have several outcomes. From the standpoint of the church involved, of course, the desired conclusion is no change in its tax-exempt status and/or tax liability. Other outcomes, however, include (1) no change in exempt status or tax liability, (a) conditioned on compliance with an IRS request to modify matters such as internal accounting practices and procedures or (b) coupled with an IRS admonition to refrain from increasing certain activities that are limited by the law of tax-exempt organizations, such as attempts to influence legislation;[110] (2) a proposal by the IRS to revoke exempt status; (3) a proposal by the agency asserting unrelated

[103]IRC § 7611(b)(4). These requirements are summarized in § 6.7(a)
[104]Church Audit Procedures Q&A 11.
[105]Church Audit Procedures Q&A 10; IRM 4.76.7.6.
[106]*Id*. Q&A 11.
[107]IRC § 7611(b)(1)(A).
[108]That is, exempt from federal income tax pursuant to IRC § 501(a) by reason of description in IRC § 501(c)(3).
[109]Also Church Audit Procedures Q&A 14. The scope of the records of a church that the IRS may examine is discussed in *United States v. C.E. Hobbs Found. for Religious Training & Education, Inc*., 93-2 U.S.T.C. ¶ 50,588 (9th Cir. 1993); *United States v. Church of Scientology Western United States*, 973 F.2d 715 (9th Cir. 1992), petition to the U.S. Supreme Court (No. 92-2002) dismissed on Oct. 6, 1993.
[110]See App. C § III A.

business income tax liability; and/or (4) a proposal asserting liability for other taxes.[111]

In certain exceptional circumstances, the IRS may, rather than proceed with an examination, propose to revoke an organization's tax exemption based on the facts and circumstances that ''form the basis for a reasonable belief to commence an inquiry under [the church audit rules] and any other appropriate information that becomes apparent as a result of the inquiry, the conference, or both.''[112]

§ 6.8 SUMMONS ENFORCEMENT

As discussed, the commencement of a church tax inquiry is predicated on IRS adherence to the more flexible *reasonable belief* standard.[113] By contrast, the valid commencement of a church tax examination rests on adherence to the *to the extent necessary* standard.[114] This latter standard has been developed in courts in the context of summons enforcement cases.

When this standard was first tested, the IRS asserted that the words ''to the extent necessary'' mean no more than that the agency must show that the requested documents are *relevant* in determining tax liability or church status.[115] This position has been uniformly rejected in judicial proceedings.

The first argument advanced by the IRS in this regard—a contention that one court of appeals conceded was ''ingenious''[116]—was that the statute should be read with emphasis on the words ''tax imposed by this title.'' Thus, according to the IRS, courts should read the statute as limiting an examination of church books and records ''to the extent necessary to determine the liability for, and the amount of, any *tax imposed by this title*.''[117] This provision, if viewed in this fashion, would employ the word *necessary* in order to forbid the IRS to look at church records ''for purposes of determining liability for some other tax, or for purposes of determining whether the church was breaking some totally different law, or perhaps just for fun.''[118] Consequently, from this perspective, assuming the IRS restricted its examination to the correct *purpose*, the agency

[111]Church Audit Procedures Q&A 11.

[112]*Id*.

[113]See § 6.6, text accompanied by *supra* note 64.

[114]IRC § 7611(b)(1).

[115]That is, the IRS initially was of the view that the basic legal tests applicable to a summons aimed at church documents are the same as the tests applicable to a typical IRS summons. The applicable tests in the context of a regular IRS summons were articulated by the Supreme Court in *United States v. Powell*, 379 U.S. 48 (1964) (see § 1.8). This position of the IRS was flawed because the agency failed to interpret the summons threshold tests by taking into consideration the spirit of the special protections afforded churches by IRC § 7611—an IRS stance that continues today in other church audit settings (see, e.g., *supra* notes 7, 74, 76).

[116]*United States v. Church of Scientology of Boston, Inc.*, 933 F.2d 1074, 1077 (1st Cir. 1991).

[117]IRC § 7611(b)(1)(A) (emphasis added).

[118]*United States v. Church of Scientology of Boston, Inc.*, 933 F.2d 1074, 1077 (1st Cir. 1991).

can look at whatever church books, documents, and other records that may be relevant.[119] As a court wrote, the problem with this argument is that the ''rest of the statute belies it.''[120] That is, the church tax inquiry standard is, as noted, the *reasonable belief* test; the church tax examination standard requires the IRS to meet the reasonable belief test *and* also meet the *to the extent necessary* requirements. The IRS's interpretation of these rules would have made the word ''and'' and the entire *to the extent necessary* rules redundant, an outcome not likely to be tolerated by a court as a matter of statutory construction.[121]

Another argument advanced by the IRS for the merely *relevant* standard was based on another tax statute, applicable with respect to all tax investigations, that provides that ''no taxpayer shall be subject to *unnecessary* examination.''[122] This contention unfolded as follows: (1) Inasmuch as, in a standard examination, the IRS may examine whatever material is relevant, an examination of relevant material cannot be an *unnecessary* examination; (2) an examination of relevant material is, therefore, a *necessary* examination; and (3) thus, the phrase *to the extent necessary* should be read as meaning *to the extent relevant*. A court observed that ''[t]his argument sounds logical, but it is not,'' noting that ''[i]n ordinary English there is a 'middle' set of circumstances that 'necessary' and 'unnecessary' do not completely distribute between them.''[123] This court dismissed this IRS argument by writing that ''an investigation of whatever documents 'might throw light' on the matter is not an 'unnecessary' investigation, but neither can one conclude that it is 'necessary,' '' in that ''[i]t might, for example, simply be somewhat helpful.''[124]

Still another of these IRS arguments was that the phrase *to the extent necessary*, if read ''naturally'' (i.e., in accordance with common meaning), would significantly hamper the agency's ability to conduct church tax examinations. This argument proceeded as follows: (1) The IRS cannot possibly know whether an examination of, for example, a certain set of books is necessary to show tax liability unless and until the agency can see the books; (2) it is absurd to expect the IRS to be able to prove liability before it starts an examination;

[119]Stated another way, this interpretation of the statute had it that any examination by the IRS relevant to determining the right sort of liability of a church is a *necessary* examination.

[120]*United States v. Church of Scientology of Boston, Inc*., 933 F.2d 1074, 1077 (1st Cir. 1991).

[121]So held in *id*, at 1077–1078.

[122]IRC § 7605(b) (emphasis added).

[123]*United States v. Church of Scientology of Boston, Inc*., 933 F.2d 1074, 1078 (1st Cir. 1991). This line of reasoning comes up in other tax law contexts, such as with the word *substantial* (e.g., in connection with the limitation on lobbying activities by tax-exempt charitable organizations (see App. C § III A); an activity may not be *substantial* but that does not necessarily lead to the correct conclusion that the activity is *insubstantial*, in that there may be an intervening gap (what the First Circuit referenced as a ''middle set of circumstances'') between the two concepts.

[124]*United States v. Church of Scientology of Boston, Inc*., 933 F.2d 1074, 1078 (1st Cir. 1991). The court's reference to the phrase ''might throw light'' is reflective of a court opinion concerning the general summons standard, in which that court wrote that the IRS need show only that the summoned documents ''might throw light upon the correctness of the taxpayer's returns'' (*United States v. Ryan*, 455 F.2d 728, 733 (9th Cir. 1971)).

(3) imposition of a higher summons standard on the IRS would place an impossible burden on the IRS with respect to any organization that claims to be a church; and (4) such a construction of the statute, which would nullify the summons authority of the IRS in the church audit context, is to be avoided. This argument was rejected by a court, which noted that the statute does not provide ''to the extent necessary to *show* liability'' but rather states ''to the extent necessary to *determine* liability,'' meaning that the IRS is required to show that the material is necessary to the *investigation*, rather than necessary to *prove liability*. This court wrote that (1) the church audit procedures statute ''focuses the court's attention on the needs of a competent investigator, not the needs of a prosecutor,'' (2) the statute ''requires the IRS to explain why the particular documents it seeks will significantly help to further the purpose of the investigation,'' and (3) ''we do not believe that the standard, while stricter than 'may be relevant,' will impose upon the IRS unreasonably strict standards of proof when it seeks material that it needs for investigatory purposes'' involving churches.[125]

Consequently, when a court reviews the issue of the validity of a summons issued by the IRS in the church tax examination context, the standard to be followed by the court is what one court termed the *necessity standard*.[126] The standard is *not* the general *relevancy standard* (used in summons enforcement

[125]*United States v. Church of Scientology of Boston, Inc.*, 933 F.2d 1074, 1079 (1st Cir. 1991). The appellate court ruled that the summons involved in this case did not meet the stricter ''necessary-to-the-investigation'' standard (*id.*).

A provision of the Internal Revenue Code that was repealed in 1984 (in tandem with enactment of the church audit procedures rules, IRC § 7805(c), also employed the *to the extent necessary* language. Courts uniformly interpreted these words in the same manner as the court did in the *Church of Scientology of Boston* case. Examples of this include *United States v. Church of World Peace*, 775 F.2d 265 (10th Cir. 1985); *United States v. Coates*, 692 F.2d 629 (9th Cir. 1982); *United States v. Dykema*, 666 F.2d 1096 (7th Cir. 1981), *cert. den.*, 456 U.S. 983 (1982); *United States v. Life Science Church of America*, 636 F.2d 221 (8th Cir. 1980); *United States v. Holmes*, 614 F.2d 985 (5th Cir. 1980). In *Holmes*, the court wrote that the ''second prong of the *Powell* test [see § 1.8] was pruned back by Congress in 1969, . . . when it added'' IRC § 7605(c) (at 988).

When the church audit rules were enacted in 1984 and Congress utilized the necessary-to-the-investigation standard, the sponsors of the legislation said that they expected the courts to continue to interpret these words in this manner: ''[T]o be certain churches are protected from unfounded examinations [the legislation] limits the inspection of church records to those necessary to determine the tax liability of a church. . . . As under present law, the IRS may examine the religious activities of an organization claiming to be a church . . . only to the extent necessary to determine if the organization actually is a church'' (130 Cong. Rec. S4486 (daily ed. April 12, 1984)).

[126]*United States v. Church of Scientology of Boston, Inc.*, 739 F. Supp. 46, 50 (D. Mass. 1990). The foregoing discussion of the church audit rules summons enforcement standard is based largely on the teachings of the U.S. Court of Appeals for the First Circuit (*United States v. Church of Scientology of Boston, Inc.*, 933 F.2d 1074 (1st Cir. 1991)). The only other federal court of appeals to consider the issue agreed wholly with the First Circuit. This other appellate court wrote that the ''meaning of 'necessary' in this context is something more than 'possibly relevant' '' and ''Congress intended to limit the summons power in cases involving churches to those necessary documents'' (*United States v. Church of Scientology Western United States*, 973 F.2d 715, 720 (9th Cir. 1992)).

proceedings generally[127]).[128] A court summarized this standard: ''To show that the summoned [church] documents are necessary, the IRS must (1) show that the purposes of its investigation are proper, and (2) explain how the particular documents, or categories of documents, (a) fall directly and logically within the scope of those purposes and (b) will help significantly to further an investigation within the scope of those purposes.''[129]

The foregoing discussion pertains to summons enforcement efforts that are directed at an IRS effort to acquire church records.[130] If a summons is for other types of records, the church audit procedures do not apply, even if the other records concern a church. For example, the term *church records* does not extend to records maintained by a third party, such as bank records.[131] In the non-church record setting, the IRS only has to show, in a summons enforcement proceeding, that the summoned documents are *relevant* to its investigation.[132]

Likewise, where an IRS investigation is directed at one or more church leaders personally, rather than at a church as such, the church audit procedures are inapplicable. Correspondingly, in any summons enforcement proceeding associated with such an investigation, the general standard as to summons enforcement applies.[133]

§ 6.9 PROTOTYPE SCENARIO

No IRS audit is precisely identical to another; thus, church audits differ substantively and procedurally. Nonetheless, what follows is an effort to sketch what the church tax law audit procedure is likely to generally entail.[134]

(a) IRS Becomes Suspicious

For one or more reasons, the IRS becomes suspicious that a tax-exempt church is violating one or more elements of the law of tax-exempt organizations.

[127]A court termed these ''run-of-the-mill'' summons enforcement proceedings (*United States v. Church of Scientology Western United States*, 973 F.2d 715, 717 (9th Cir. 1992)).

[128]A court characterized the summons enforcement standard employed in the church audit context the ''modified *Powell* test'' (*United States v. Church of Scientology of Boston, Inc.*, 739 F. Supp. 46, 48 (D. Mass. 1990)).

[129]*United States v. C.E. Hobbs Found. for Religious Training & Education, Inc.*, 91-2 U.S.T.C. ¶ 50,444 (9th Cir. 1993).

[130]See § 6.5.

[131]The term *church records* excludes from its scope records acquired ''pursuant to a summons to which section 7609 applies'' (IRC § 7611(h)(4)(B)(i)).

[132]For example, *United States v. C.E. Hobbs Found. for Religious Training & Education, Inc.*, 91-2 U.S.T.C. ¶ 50,444 (9th Cir. 1993).

[133]For example, *St. German of Alaska Eastern Orthodox Catholic Church et al. v. United States*, 840 F.2d 1087 (2nd Cir. 1988), *aff'g* 653 F. Supp. 1342 (S.D.N.Y. 1987). Likewise (under the law prior to enactment of the church audit rules), *Assembly of Yahveh Beth Israel et al. v. United States*, 87-1 U.S.T.C. ¶ 9353 (D. Col. 1984).

[134]This scenario is based on the author's experiences. In general, IRM 4.76.7.7.

For example, the agency may be of the view that a church may be operating in a commercial manner,[135] transgressing the private inurement doctrine,[136] and/or engaging in political campaign activity.[137] The church may be aware of the basis of the agency's suspicion(s), which may be a media report or a complaint filed with the IRS. For purposes of this sketch, assume that the sole reason that the IRS began the investigation of a church (*Church*)[138] was because of reports that the Church has been engaged in political campaign activities.

(b) Notice of Church Tax Inquiry

Thus, the Church's mail one day brought an IRS notice of tax inquiry. This notice (1) contained the above-quoted two opening paragraphs, (2) a statement that the IRS has a reasonable belief that the Church has engaged in political campaign activities, (3) a summary of the sources of information on which this belief rests (including newspaper articles), (4) an attachment consisting of a series of 50 questions, and (5) another attachment, which is the statement of the Church's administrative and constitutional rights in this regard, including the right to a conference. This notice, signed by the Director, Exempt Organizations Examinations, states that ''[i]f your response [to the questions] resolves our concerns about your exempt status and tax liability, it will not be necessary to pursue this matter further.'' This notice of church tax inquiry satisfied all requirements in the law as to content.

Within 30 days of receipt of the church tax inquiry, the Church submitted, in a 30-page, single-spaced document, detailed answers to these questions, accompanied by relevant documents. In a letter to the IRS accompanying this submission, legal counsel for the Church wrote: ''We are confident that this response will alleviate any concerns the IRS may have regarding any political campaign activity by the Church.''

(c) Notice of Church Tax Examination

About 60 days thereafter, the IRS sent a notice of church tax examination to the Church. Thanking the Church for its response to the church tax inquiry notice, the IRS wrote that ''we still think an examination of your books and records may be necessary to resolve our concerns about whether the church has engaged in political campaign intervention activities that could jeopardize its tax-exempt status as a church.'' The notice referenced the Church's right to a conference with IRS officials and enclosed copies of all documents collected or prepared by the IRS for use in the examination, disclosure of which is required

[135]See Appendix C § XII F.
[136]See *id*. § II D.
[137]See *id*. § IV A.
[138]This church is assumed to be a bona fide church.

by the Freedom of Information Act. This notice, signed by the Director, Exempt Organizations Examinations, satisfied all requirements in the law as to content.

Also attached to this notice of church tax examination were drafts of five information document requests (IDRs),[139] describing the records that the IRS sought to examine to make its determination. In the notice, the IRS noted that the Church did not need to respond to the document requests ''at this time.'' Some of the records identified in these IDRs had no direct correlation with, and went far beyond, the matter of political campaign activity. The Church requested a conference.

(d) Conference

Representatives of the Church and the IRS conferred. Legal counsel for the Church properly recorded, in a memorandum, the names and titles of each of the conferees, and the substance of what transpired at the conference. Following the conference, legal counsel for the Church sent a letter to the IRS, contending that the conference should have resolved any lingering concerns the agency may have had about political campaign activity and the Church. The concerns of the IRS nonetheless were not allayed; the Church sent voluntary responses to the IDRs to the IRS. The appropriate representative of the IRS, about two months later, sent a letter to the Church, thanking it for sending the information and stating that the examination would continue. Thereafter, the IRS sent more IDRs to the Church, opening seven more lines of investigation.[140]

§ 6.10 TWO-YEAR COMPLETION RULE

The IRS is required to complete a church tax inquiry[141] or church tax examination, and make a final determination with respect to the inquiry or examination, not later than two years after the examination notice date.[142] The term *examination notice date* means the date the notice with respect to a church tax examination is provided[143] to the church.[144]

The running of this two-year period is suspended for any period during which (1) a judicial proceeding brought by a church against the IRS with respect

[139]IRS Form 4564. See, e.g., § 1.4.

[140]This all-too-typical scenario demonstrates that the IRS does not fully appreciate the sensitivities involved in connection with the audits of churches or the heightened standards with which the IRS must comply in proceeding with the examination of a church. In some instances, the IRS does not comply fully with the procedures governing the agency's examinations of churches. This scenario illustrates how easy it is—unless the IRS is challenged—for the agency to basically approach an audit of a church in essentially the same manner as the audit of any other type of tax-exempt organization.

[141]Inexplicably, the statute at this point (and only at this point) refers to the procedure as the *church tax status inquiry* (IRC § 7611(c)(1)(A)).

[142]IRC § 7611(c)(1)(A).

[143]See § 6.7.

[144]IRC § 7611(h)(6).

to the church tax inquiry or examination is pending or being appealed,[145] (2) a judicial proceeding brought by the IRS against the church or any official of the church to compel compliance with any reasonable request of the IRS in a church tax examination for examination of church records or religious activities is pending or being appealed, or (3) the IRS is unable to take actions with respect to the church tax inquiry or examination by reason of an order issued in a judicial proceeding involving access to third-party records.[146] This two-year period is also suspended for any period in excess of 20 days, but not in excess of six months, in which the church or its agents fail to comply with any reasonable request of the IRS for church records or other information.[147] This two-year period can be extended by mutual agreement of the church and the IRS.[148]

§ 6.11 NINETY-DAY COMPLETION RULE

If the IRS does not send a notice of examination after sending the notice of inquiry, the IRS must complete the inquiry, and make a final determination with respect to it, within 90 days after the inquiry notice date.[149] The *inquiry notice date* is the date the notice with respect to a church tax inquiry is provided[150] to the church.[151] This period is counted from the day after the inquiry notice is mailed. A church tax inquiry is concluded when the results of the inquiry or, if appropriate, the notice of examination is mailed. For example, if an inquiry notice is mailed on November 1, 2007, the church tax inquiry must be concluded, in the absence of a permissible suspension of the period, on or before January 30, 2008.[152]

A church tax examination commences when the church tax examination notice is mailed. A church tax examination must be concluded not later than the date that is two years after the examination notice date. This period is counted from the day after the examination notice is mailed. A church tax examination is concluded when the final determination is mailed. For example, if the examination notice is mailed on November 16, 2007, the final determination must be made, in the absence of a permissible suspension of the period, on or before November 16, 2009.[153]

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[145]This is a discordant reference, in that an appeal is not among the remedies in the case of a violation of the church audit procedures (see § 6.14).
[146]IRC § 7611(c)(2)(A). This third element is the subject of IRC § 7609.
[147]IRC § 7611(c)(2)(B).
[148]IRC § 7611(c)(2)(C). Also Church Audit Procedures Q&A 13.
[149]IRC § 7611(c)(1)(B).
[150]See § 6.6.
[151]IRC § 7611(h)(5).
[152]Church Audit Procedures Q&A 13a.
[153]*Id*.

This 90-day period is suspended during any period for which the two-year period for duration of a church audit[154] would be suspended.[155] The 90-day period, however, ''is not to be suspended because of the church's failure to comply with requests for information made prior to the notice of examination.''[156] If an inquiry or examination is terminated by reason of this rule, any further inquiry or examination regarding the same or similar issues within a five-year period must be approved by the IRS.[157]

§ 6.12 SPECIAL LIMITATION PERIODS

The appropriate IRS regional counsel must determine in writing that (when it occurs) there has been substantial compliance by the IRS with the church audit procedures and approve in writing of a conclusion that the tax-exempt status of a church should be revoked, or that a notice of deficiency be sent or a tax assessed, before the IRS can determine that (1) an organization is not entitled to tax-exempt status as a church, (2) an organization is not a church that is eligible to receive tax-deductible contributions, or (3) a notice of tax deficiency be sent to a church following a church tax examination (or, in cases where the deficiency procedures are inapplicable, there be an assessment of any underpayment of tax by the church following a church tax examination).[158]

As to church tax examinations regarding revocation of tax-exempt status, a federal tax (other than the tax on unrelated business taxable income) may be assessed, or a proceeding in court for collection of the tax may be initiated without assessment, only for the three most recent tax years preceding the date on which the notice of examination (the second notice) is sent to the church.[159] If a church is proven to not be eligible for exemption for any of these three years, the IRS may assess tax (or proceed in court without assessment), as part of the same audit, for a total of six years preceding the date of the notice of examination.[160]

For examinations concerning qualification for tax-exempt status, the examination is limited initially to an examination of church records that are relevant to a determination of tax status or tax liability for the three most recently completed tax years ending before the examination notice date. If it is determined that an organization is not a church exempt from tax for one or more of

[154]See § 6.10, text accompanied by *supra* note 142.
[155]IRC § 7611(c)(2).
[156]H. Rep. No. 861, 98th Cong., 2nd Sess. 1104 (1984).
[157]IRC § 7611(f).
[158]IRC § 7611(d)(1). Also Church Audit Procedures Q&A 11.
[159]IRC § 7611(d)(2)(A)(i).
[160]IRC § 7611(d)(2)(A)(ii).

the three most recently completed tax years and no return has been filed for the three years ending before the three most recently completed tax years, an examination of relevant records may be made, as part of the same examination, for the six most recently completed tax years ending before the examination notice date. (This assumes that no returns were filed for any of the three years to which the examination is to be extended. If a return was timely filed for any such year, the filing of that return determines the applicable statute of limitations for that year in the absence of other factors, for example, fraud, willful tax evasion, or substantial understatement, which ordinarily would extend the statute of limitations.)[161]

An organization is determined not to be a tax-exempt church for one or more of the three most recently completed tax years ending before the examination notice date, when the Director, EO Examinations, approves, in writing, the completed findings of the examining agent that the organization is not an exempt church for one or more of those years. This Director may not delegate this approval to a subordinate official. The completed findings of the examining agent, as approved by the appropriate Regional Commissioner for this purpose, do not constitute a final revenue agent's report for purposes of the tax-exempt organizations declaratory judgment rules.[162] Church records of a year earlier than the third or sixth completed tax year, as applicable, may be examined if material to a determination of tax-exempt status during the applicable three- or six-year period.[163]

For church tax examinations relating to unrelated business activities, where a return has not been filed by a church, the IRS may assess or proceed to collect tax with respect to the six most recent tax years ending before the examination notice date.[164] Church records of a year earlier than the sixth year may be examined if material to a determination of unrelated business income tax liability during the six-year period.[165] For examinations involving issues other than revocation of tax-exempt status or unrelated business (such as examinations pertaining to Social Security or other employment taxes), there is no limitation period where a return has not been filed.[166]

The special limitation periods for church tax liabilities may not be construed to increase an otherwise applicable limitation period.[167] Thus, as under general law, a three-year limitation period applies where a church filed a tax return before an examination was held and did not substantially understate income.[168]

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[161]Church Audit Procedures Q&A 15.
[162]*Id*. These rules are the subject of § 1.13(b).
[163]Church Audit Procedures Q&A 15.
[164]IRC § 7611(d)(2)(B).
[165]Church Audit Procedures Q&A 15.
[166]*Id*.
[167]IRC § 7611(d)(2)(C).
[168]See § 3.11.

There is no limitation period in a case of fraud, willful tax evasion, or knowing failure to file a return that should have been filed.[169] The applicable limitation period may be extended by mutual agreement of the church and the IRS.

§ 6.13 LIMITATIONS ON ADDITIONAL INQUIRIES AND EXAMINATIONS

If a church tax inquiry or church tax examination is completed and does not result in (1) a revocation of tax exemption, notice of deficiency, or assessment, or (2) a request by the IRS for a significant change in the operational practices of a church (including the adequacy of accounting practices), another church tax inquiry or examination may not commence with respect to the church during the applicable five-year period unless the inquiry or examination is approved in writing by the IRS Assistant Commissioner (EP/EO) or does not involve the same or similar issues involved in the preceding inquiry or examination.[170] For this purpose, an inquiry or examination must be treated as completed not later than the expiration of the applicable period under the two-year completion rule or the 90-day completion rule.[171] The term *applicable five-year period* means the five-year period beginning on the inquiry notice date or the examination notice date, unless there is an appropriate suspension of the period.[172]

Thus, this IRS approval requirement is inapplicable where the second audit does not involve the same or similar issues as the preceding inquiry or examination; the requirement applies only to second audits beginning within five years of the date on which the notice of examination was sent to the church during the prior audit (or, if a notice of examination was not sent, the date of the notice of commencement of the inquiry). In determining whether a second audit involves issues *similar to* those of a prior audit, the ''substantive factual issues involved in the two audits, rather than legal classifications, will govern'' and ''unrelated business income from different sources will be considered different issues'' for this purpose.[173] For example, where a prior examination and a current examination of unrelated business income involve income from different sources, the current examination involves different issues than the prior examination and the approval of the Assistant Commissioner is unnecessary.[174]

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[169]Church Audit Procedures Q&A 15.
[170]IRC § 7611(f)(1). Also Church Audit Procedures Q&A 16.
[171]*Id*. See §§ 6.10, 6.11.
[172]IRC § 7611(f)(2).
[173]H. Rep. No. 861, 98th Cong., 2nd Sess. 1110 (1984).
[174]Church Audit Procedures Q&A 16; IRM 4.76.7.9.4.

§ 6.14 LIMITED REMEDY FOR IRS VIOLATIONS OF PROCEDURES

The exclusive remedy for an IRS violation of the church audit procedures is this: Failure of the agency to substantially comply with (1) the church tax inquiry or church tax examination notice requirements,[175] (2) the requirement that an offer of an IRS conference with the church be made (and a conference held if requested),[176] or (3) the requirement that the Director, EO Examinations, approve the commencement of a church tax inquiry,[177] will result in a stay of proceedings in a summons proceeding to gain access to church records (but not in dismissal of the proceeding) until a court finds that all practicable steps to correct the noncompliance have been taken.[178] The two-year limitation on the duration of a church audit[179] is not suspended during these stays of summons proceedings; the IRS, however, may correct the violations without regard to the otherwise applicable time limits prescribed under the church examination procedures.[180] In determining whether a stay is necessary, a court ''will consider the good faith of the IRS and the effect of any violation of the proper examination procedures.''[181]

Otherwise, there is no judicial remedy for an IRS violation of the church audit procedures. The failure of the IRS to comply with these rules may not be raised as a defense or as an affirmative ground for relief in a judicial proceeding, including a summons proceeding to gain access to church records, a declaratory judgment proceeding involving a determination of tax-exempt status,[182] or a proceeding to collect unpaid tax. Additionally, failure to substantially comply with the requirement that two notices be sent, that the appropriate IRS Regional Commissioner approve an inquiry, and that a conference be offered (and held if requested) may not be raised as a defense or as an affirmative ground for relief in a summons proceeding or other judicial proceeding other than as specifically previously stated.[183] A church or its representatives cannot ''litigate the issue of the reasonableness of the [IRS representative's] belief in approving the commencement of a church tax inquiry . . . in a summons proceeding or any other judicial proceeding,'' although this does not derogate from a church's ''right to raise any substantive or procedural

[175]See text accompanied by *supra* notes 69, 88.
[176]See text accompanied by *supra* note 89.
[177]See text accompanied by *supra* note 63.
[178]IRC § 7611(e)(1). Also IRM 4.76.7.9.3.
[179]See § 6.10.
[180]IRC § 7611(e)(1).
[181]H. Rep. No. 861, 98th Cong., 2nd Sess. 1114 (1984). Also Church Audit Procedures Q&A 17.
[182]That is, a proceeding pursuant to IRC § 7428. See § 3.13(b).
[183]IRC § 7611(e)(2).

argument which would be available to taxpayers generally in the appropriate proceeding.''[184]

§ 6.15 EXHAUSTION OF ADMINISTRATIVE REMEDIES RULE

Any final report of an IRS agent is treated as an IRS determination for purposes of the tax-exempt organizations declaratory judgment rules.[185] A church receiving such a report must be treated, for purposes of these rules and the rules concerning the awarding of costs and fees,[186] as having exhausted the administrative remedies available to it.[187]

§ 6.16 INTERPLAY WITH INTERMEDIATE SANCTIONS RULES

The church audit procedures are used by the IRS in initiating and conducting any inquiry or examination into whether an excess benefit transaction[188] has occurred between a church and a disqualified person with respect to the church.[189] The reasonable belief required to initiate a church tax inquiry[190] is satisfied if there is a reasonable belief that an intermediate sanctions excise tax is due from a disqualified person with respect to a transaction involving a church.[191]

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[184]H. Rep. No. 861, 98th Cong., 2nd Sess. 1114 (1984). Also Church Audit Procedures Q&A 17. An illustration of the applicability of these rules so as to preclude an audit of a church appears in *United States v. Church of Scientology of Boston, Inc.*, 739 F. Supp. 46 (D. Mass. 1990), *aff'd*, 933 F.2d 1074 (1st Cir. 1991), interpreting, in this context, *United States v. Powell*, 679 U.S. 48 (1964). Also *United States v. Church of World Peace*, 775 F.2d 265 (10th Cir. 1985); *United States v. Church of Scientology Flag Service Organization, Inc.*, 90-1 U.S.T.C. ¶ 50,019 (M.D. Fla. 1989); *United States v. Church of Scientology Western United States*, 92-1 U.S.T.C. ¶ 50,441 (9th Cir. 1992).

[185]IRC § 7611(g). These rules are the subject of § 3.13(b).

[186]IRC § 7430.

[187]IRC § 7611(g).

[188]See App. C § II F.

[189]Reg. § 53.4958-8(b).

[190]See § 6.6, text accompanied by note 64.

[191]Reg. § 53.4958-8(b). Also Church Audit Procedures Q&A 19. In general, Comment, ''An End to Politically Motivated Audits of Churches? How Amendment to Section 7217 Can Preserve Integrity of the Tax Investigation of Churches Under Section 7611,'' 60 *Tax Law*. (no. 2) 503 (Winter 2007); Walker & Holub, ''Audit of Church-Related Schools and Churches,'' 24 *Cath. Law*. 184 (1979); Worthing, ''The Internal Revenue Service as a Monitor of Church Institutions: The Excessive Entanglement Problem,'' 45 *Fordham L. Rev*. 929 (1977); Shaw, ''Tax Audits of Churches,'' 22 *Cath. Law*. 247 (1976).

By letters dated November 5, 2007, Senator Charles E. Grassley (R-IA), ranking minority member of the Senate Finance Committee, launched inquiries into the operations and finances of six churches (ministries). As of publication date, it was not clear what the responses of these churches will be to this investigation, raising as it does constitutional law, privacy, and church audit procedures issues. There is a splendid irony here, however, in that Sen. Grassley was the principal proponent of IRC § 7611.

CHAPTER SEVEN

Tax-Exempt Organizations Examination Issues

The IRS developed guidelines that are specifically targeted to examinations of various types of tax-exempt organizations.[1] These guidelines spell out for the examining agent the issues to be identified and developed that are unique to the entity under review. This chapter consists of a summary of the issues that are likely to be encountered in connection with an IRS examination of a particular type of exempt organization.[2]

§ 7.1 CATEGORIES OF TAX-EXEMPT ORGANIZATIONS

These examination guidelines include information for the examiner concerning 29 categories of tax-exempt organizations.

(a) Single-Parent Title-Holding Corporations

When the IRS examines the organization and operation of a single-parent title-holding corporation,[3] the assumption should be that at least seven issues will be reviewed:

1. *Exempt status of parent.* The examiner will verify the current tax-exempt status (assuming that is the case) of the parent organization. This will be done by obtaining a copy of the parent organization's determination letter from the Integrated Data Retrieval System.[4]
2. *Organizing documents.* The examiner will review the organization's governing instruments to determine whether it is properly organized for its exempt purpose. Where the operations are permissible but a document contains unsuitable language, the examining agent is to accord the organization to correct the matter by appropriately amending the document.
3. *Multiple parents.* In general, inasmuch as this type of exempt organization may have only one parent, the examiner will determine if the entity has

[1]These guidelines are collected at IRM 4.76.
[2]These guidelines are not all-inclusive; the examining agent is not precluded from raising one or more other issues.
[3]That is, an organization the tax exemption of which is (ostensibly) based on IRC § 501(c)(2). See App. C § I A.
[4]See § 5.30.

two or more parents. Multiple parents are permissible where they are related.[5]

4. *Relationships.* Usually, a single-parent title-holding company is a subsidiary with respect to its parent(s). Therefore, the IRS examiner will ascertain whether there is the requisite control or ownership of the company by an exempt parent.
5. *Distribution of income.* The examiner will determine whether the title-holding entity is turning over the entire amount of its income (less expenses), as required, to the exempt parent. Mere accrual of income for the parent is insufficient. Generally, the IRS will allow the organization until the end of the succeeding tax year to make the requisite distribution.
6. *Sources of income.* These types of organizations may hold title to property producing passive investment income; permissible sources of income thus are securities, certain types of oil and mineral interests, and real estate. The IRS will look to determine if the organization is impermissibly actively involved in an investment arrangement that amounts to a business, such as securities trading or a working interest, for example, one where the holder of the interest is responsible for a portion of the operating costs of oil or mineral production.
7. *Unrelated business income.* Generally, a single-parent title-holding corporation cannot have unrelated business income. Consequently, the examiner will ascertain whether the organization is receiving that type of income and, if it does, whether one or more exceptions to this rule are available.[6]

(b) Charitable, Educational, and Like Organizations: General Rules

When the IRS examines the organization and operation of a charitable organization,[7] the assumption should be that at least 10 issues will be reviewed:

1. *Financial transactions.* The examiner will determine whether the organization engaged in any financial transactions, including the payment of compensation, which may result in private inurement,[8] impermissible private benefit,[9] and/or one or more excess benefit transactions.[10] Thus,

[5]The examiner may, in these circumstances, contemplate whether the organization should be tax-exempt as a multi-parent title-holding entity. See § 7.1(z); App. C § I Z.
[6]IRM 4.76.1.
[7]That is, an organization the tax exemption of which is (ostensibly) based on IRC § 501(c)(3). This includes charitable, educational, scientific, and religious organizations. See App. C §§ I B–H.
[8]See App. C § II D.
[9]See *id*. § II E.
[10]See *id*. § II F.

from this perspective, the examiner will review salary and other compensation amounts, employee and independent contractor contracts, reimbursable travel expenses, sales or exchanges of property, and other financial transactions.

2. *Lobbying.* The examiner will ascertain whether the organization is in compliance with the limitation as to lobbying activities by charitable organizations.[11] This will be done by means of discussions with the organization's employees and officers, review of financial records and publications, payments to consultants, and dues paid to organizations. The examiner usually will determine whether the organization has made the election to be under the expenditure test or is subject to the substantial part test.
3. *Political campaign activities.* The examiner will ascertain whether the organization has transgressed the prohibition on political campaign activity by charitable organizations.[12]
4. *Restricted contributions.* The examiner will review contributions made to the organization, in an effort to determine whether there are restrictions on gifts that benefit the business or private interests of donors and that may jeopardize the exempt status of the organization.[13]
5. *Planned gifts.* The examiner will determine whether the rules concerning charitable remainder trusts, pooled income funds, and other planned giving vehicles are being followed.[14]
6. *Quid pro quo contributions.* The examiner will review the organization's files to determine if it has been in compliance with the quid pro quo contribution rules.[15]
7. *Gift substantiation rules.* The examiner will determine whether the organization has been complying with the rules requiring written substantiation of charitable gifts of $250 or more.[16]
8. *Property valuations.* The examiner will endeavor to determine whether the value placed on contributions of property such as closely held securities, personal property, and real property is reasonable.[17]

[11]See *id*. § III A.
[12]See *id*. § IV A.
[13]See *id*. § XIII C.
[14]See *id*. § XIII D.
[15]See *id*. § XIV C.
[16]See *id*. § XIV B.
[17]See *id*. § XIII B. This information should be readily available to the extent it relates to the value of the gift property assigned to it by the charitable organization; the organization, however, may not have records to establish the value placed on the property by the donor.

9. *Gift property sales.* The examiner will, in an instance of property sold soon after its contribution, compare the sales price to the value assigned to the property by the donor.[18]

10. *Unrelated business.* The examiner will review activities that generate revenue for the organization to determine if the organization has unrelated business income.[19] This will include a determination as to whether an activity constitutes a business, whether the business is regularly carried on, and whether the business undertaking is substantially related to the organization's exempt purposes. Activities that are specifically identified for analysis include the sale of advertising, sale of mailing lists, sale of pharmaceuticals by a hospital to non-patients, sale of souvenirs by a museum, sponsorship of commercially sponsored scientific research, sale of art objects at an exhibit, rental by a university of sports facilities, operation of a health club, and travel tours.[20]

(c) Religious Organizations

The IRS has examination guidelines specifically for religious organizations, including churches and religious orders. These guidelines reiterate that the examiner should explore issues including the organizational and operational tests, private inurement, impermissible private benefit, substantial legislative activities, political campaign activities, public charity status, commercial operations, and unrelated business activities. Particular emphasis is placed on the matter of political activities.

These guidelines focus on a religious organization's publishing activities, observing that, while the publication of literature is an ''important method of disseminating religious views,'' publishing ''may also be a business operating in competition with commercial enterprises.'' Thus, the examiner is exhorted to determine such facts as whether the organization charges fees for its publications, whether it operates a bookstore, whether it sells to the public, the criteria used to select publishing projects, the manner by which the organization distributes publications, and any factors that distinguish the organization's publishing activities from those of a for-profit enterprise.

The guidelines also ask the examiner to inquire as to how any broadcasting activities further religious purposes and how the broadcasting activities are distinguishable from those of a commercial enterprise.[21]

The IRS examination guidelines also address the matter of examinations of churches. This is the subject of special rules that restrict the extent and manner of IRS contacts to determine qualification for tax-exempt and/or church (public

[18]See App. C § VIII C.
[19]See *id*. § IX.
[20]IRM 4.76.2.
[21]IRM 4.76.6.

charity) status, and liability for a federal tax of an organization that claims to be a church.[22] Thus, in addition to exempt and church status, these special procedures apply with respect to the conduct of (alleged) unrelated business activity, activities subject to other federal taxes (such as employment tax), and to (alleged) excess benefit transactions between a church and one or more disqualified persons.[23]

(d) Private Schools

The IRS has examination procedures for private schools, which include primary and secondary schools, colleges and universities, and professional and trade schools. Generically, for federal tax purposes, a *school* is an educational organization that normally maintains a regular faculty and curriculum, and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.[24]

When the IRS examines the organization and operation of a charitable organization,[25] the assumption should be that at least seven issues will be reviewed:

1. *Racial nondiscriminatory policy.* A private school, to be tax-exempt, must adopt and operate in accordance with a racially nondiscriminatory policy as to students.[26] Moreover, the IRS expects an exempt school to also demonstrate that its ''actual operations are in good faith furtherance of the stated policy.''[27] The guidelines include factors to establish a rebuttable inference that a private school has a history of racial discrimination. The federal tax law imposes certain recordkeeping and publication requirements in this regard, as does law administered by the Department of Education. It may be assumed that this issue will be foremost in the mind of an IRS examiner; the extensive and nearly exclusive attention accorded this subject in the guidelines buttresses the point.[28]
2. *Other issues.* The specific examination guidelines for tax-exempt schools do not address any other issues; nonetheless, all of the issues applicable

[22]IRC § 7611. See Chapter 6.
[23]IRM 4.76.7.
[24]See App. C § I D.
[25]That is, an organization the tax exemption of which is (ostensibly) based on IRC § 501(c)(3). This includes charitable, educational, scientific, and religious organizations. See App. C §§ I B–H.
[26]See App. C § I D.
[27]Also: The ''ultimate test for racially nondiscriminatory operations is equal availability to all racial and ethnic groups,'' and the ''most conclusive fact would be attendance by a substantial number and variety of minority students.''
[28]The examiner will complete a ''Private School Checksheet'' (Form 5788) to assure that all of the required checks have been made and information secured.

to charitable organizations generally[29] apply in the case of schools. Thus, an IRS examination of a school will encompass the doctrines of private inurement and private benefit, the lobbying and political campaign activities rules, the various charitable contributions rules, and the unrelated business rules.

These rules apply to separately organized or incorporated church-related schools (that do not claim to be a church). The IRS examination guidelines are generally applicable to charter schools. Colleges and universities are a ''designated industry'' under the IRS's industry specialization program; thus, an examiner contemplating an audit of one of these institutions is required to contact the Senior Technical Advisor[30] to ''improve communication and consistency in [the] treatment of issues.''[31]

(e) Public Interest Law Firms

The IRS has examination guidelines for public interest law firms, that is, organizations that directly engage in litigation as a substantial part of their activities for what they determine is in the public interest.[32] The issues that will likely arise during an IRS examination of these entities are the following:

1. *Public interest.* The examiner will analyze the firm's litigation activities to determine whether the activities in fact serve a public interest or whether a form of private interest is being served. Examiners are advised by the examination guidelines that they ''should not be reluctant'' to request technical advice[33] ''if some doubt exists as to the propriety of the organization's litigation activities.''
2. *Reporting.* The examiner will determine whether the firm has filed the requisite attachment to its annual information return describing the cases litigated and how the litigation serves a public interest, and if so whether the disclosures were accurate.
3. *Compensation arrangements.* The examiner will inquire as to whether the firm is in compliance with the rules as to when these entities can accept attorney's fees.
4. *Charitable deductions.* The examiner is expected to determine whether there are any direct or indirect arrangements to allow a charitable contribution deduction for the cost of litigation that is for the private benefit of the donor.

[29]See § 7.1(b).
[30]See § 2.4(a).
[31]IRM 4.76.8.
[32]See App. C § I E.
[33]See § 1.9.

5. *Charitable organizations rules.* To be tax-exempt, a public interest law firm must comport with the rules applicable to charitable organizations generally.[34]

(f) Educational Organizations

An organization can be a tax-exempt educational organization without qualifying as a school.[35] The two issues that will be of greatest concern to an IRS examiner, in addition to compliance with the exemption rules generally,[36] are whether the organization is engaging in propagandizing and the conduct of scholarship programs. Examiners are cautioned that they should ''maintain a position of disinterested neutrality with respect to the beliefs advocated by an organization, and must not attempt to judge the merits of an organization's educational or artistic efforts.''

1. *Methodology test.* The IRS will employ its methodology test[37] to determine if an organization's materials are educational in nature rather than propaganda. Factors to be evaluated include the presentation of viewpoints unsupported by facts as a significant component of the organization's communications, the use of facts that purport to support the viewpoints that are distorted, and the substantial use by the organization of ''inflammatory and disparaging terms.'' The guidelines note that an organization may be an action organization[38] even if its materials are educational because the activity may constitute attempts to influence legislation.

2. *Scholarships.* The examiner is to analyze an organization's scholarship (or fellowship) program to determine if it serves private interests.[39] This examination includes an assessment of whether the group of potential recipients constitutes a charitable class, there is a relationship between contributors to the organization and scholarship recipients, and the selection criteria are objective and nondiscriminatory.[40]

(g) Scientific Organizations

The issues that will be of greatest concern to an IRS examiner of a tax-exempt scientific organization,[41] in addition to compliance with the exemption rules

[34]IRM 4.76.9. See § 7.1(b).
[35]See App. C § I F.
[36]See § 7.1(b).
[37]See App. C § I F.
[38]See *id*. §§ III, IV.
[39]Private foundations are subject to special rules in this regard (see *id*. § V F). This aspect of the guidelines assumes that the educational entity is a public charity.
[40]IRM 4.76.11.
[41]See App. C § I G.

generally,[42] include whether the organization is engaging in scientific research and whether that research is in the public interest.

1. *Research.* The examiner will review the organization's project lists and plans, catalogues, agreements, minutes, and similar documents to determine whether its activities constitute research (as opposed to, for example, commercial or industrial testing) and, if it does, the types of research in which the organization engages. Sources of income will be analyzed from this perspective.
2. *Public interest.* Documentation will be reviewed to determine if the organization retains ownership or control of more than an insubstantial portion of the patents, copyrights, processes, or formulas resulting from its research and does not make the patents and the like available to the public.
3. *Private benefit.* The IRS examiner will endeavor to understand how the organization selects its projects, looking for research for the same sponsor, if research services are provided to a single firm, and/or other evidence of potential private benefit. Likewise, the examiner is to attempt to ascertain whether ''nonqualified persons occupy well-paid positions.''[43]

(h) Amateur Athletic Sports Organizations

There are several ways an amateur athletic sports organization can qualify for tax exemption as a charitable or educational organization, including as a qualified amateur sports organization.[44] The issues to be covered by an examination include:

1. *Scope of training or competition.* The examiner will determine whether the organization ''links'' to national or international competition or is local in nature. He or she may explore whether the athletes in the program ''demonstrate a certain level of talent and achievement,'' and whether the training is ''intensive'' and daily as opposed to sponsorship of weekend events. The examiner will inquire as to whether the sport involved is an event in the Olympic or Pan-American Games and whether the organization is a member of the U.S. Olympic Committee.
2. *Social or recreational programs.* The examiner will attempt to determine whether social and educational activities predominate in relation to charitable and educational programs.[45]

[42]See § 7.1(b).
[43]IRM 4.76.12 §§ 2, 2.1.
[44]See App. C § I H.
[45]IRM 4.76.12 § 3.

(i) Social Welfare Organizations

The IRS examiner of a tax-exempt social welfare organization[46] has many issue areas to explore. The principal ones are the following:

1. *Social welfare activities.* The examiner will inspect the organization's books and records to determine the nature of the activities of the organization and whether the activities are social welfare in nature, that is, whether they promote the common good and general welfare of a community. Of particular importance in this context is identification of the requisite *community*.[47] Areas involving nonqualifying activities include the conduct of activities for the benefit of a private group of individuals, carrying on of a business with the public, and participation or intervention in political campaigns. Veterans' organizations[48] and homeowners' associations[49] may qualify as exempt social welfare organizations.
2. *Social activities.* Social activities are far different than social welfare activities; the examiner will look to see whether the organization is operating primarily as a social club.[50] This will be an area of particular focus if the organization has a membership; if it does, the examiner will explore the rights, privileges, services, and activities that are provided to the members.
3. *Legislative activities.* A tax-exempt social welfare organization may engage in attempts to influence legislation without limitation, inasmuch as lobbying can further social welfare purposes. Like all exempt organizations, however, social welfare organizations are subject to the primary purpose rule;[51] thus, the examiner will determine whether any lobbying is not germane to the accomplishment of social welfare purposes, including lobbying that is engaged in to advance the financial interests of its members or to advance the interests of a particular industry or profession.
4. *Insider transactions.* Exempt social welfare organizations are subject to the doctrine of private inurement[52] and are applicable tax-exempt organizations for purposes of the intermediate sanctions rules.[53] (The IRS seems to be of the view that the private benefit doctrine[54] is

[46]See App. C § I I.
[47]Having said that, there are hundreds of tax-exempt social welfare organizations that do not serve any community, such as national and regional advocacy organizations.
[48]See App. C § I X.
[49]See *id*. § I FF.
[50]See *id*. § I N.
[51]See *id*. § II C.
[52]See *id*. § II D.
[53]See i*d*. § II F.
[54]See *id*. § II E.

applicable to social welfare organizations.) The IRS examiner will be looking for ''indications of questionable transactions'' with disqualified persons and other insiders.

5. *Unrelated business.* Exempt social welfare organizations are subject to the unrelated business rules.[55] From this perspective, the IRS examiner will review the organization's activities and income, including fundraising, to determine if it is carrying on business activities with the public in a manner similar to for-profit organizations.[56]

(j) Local Associations of Employees

An IRS examiner exploring the activities of a local association of employees[57] will review these issues:

1. *Local requirement.* This type of association must confine its operations to a *locality*; the IRS examiner will explore the boundaries imposed by this rule.
2. *Membership requirements.* The membership of this type of organization must be limited to employees of one or more designated employers in a particular locality. The IRS examiner will ascertain whether these elements are being complied with.
3. *Net earnings.* The IRS examiner will determine whether the organization's net earnings are being used for charitable, educational, and recreational activities, as is required. These organizations may not provide retirement, medical, or similar benefits to their members.
4. *Other issues.* These organizations are subject to the doctrine of private inurement, the intermediate sanctions rules, and the unrelated business rules.[58]

(k) Labor Organizations

In general, federal income tax exemption is available for organizations the purpose of which is the betterment of the conditions of those engaged in the pursuits of labor; these entities are associations of workers who have combined to protect or promote the interests of all members by bargaining collectively with their employers to secure better working conditions, wages, and similar benefits.[59] The issues to be reviewed by IRS examiners include the following:

1. *Membership requirements.* The examiner will review the membership requirements, including any classes of members, looking to detect the

[55]See *id*. § IX.
[56]IRM 4.76.13.
[57]See App. C § I J.
[58]IRM 4.76.13.5.
[59]See App. C § I K.

involvement of any entrepreneurs or independent contractors who are members. This will include an examination of the manner in which dues are paid (such as by an employer by means of withholding).

2. *Private inurement.* The private inurement doctrine[60] is applicable to tax-exempt labor organizations. Examples of potential inurement are excessive and/or underreporting of compensation to insiders (including bonuses noncompliance with accountable plans),[61] member and employee benefits, inappropriate use of facilities, unusual purchases of services and/or supplies, and loans to insiders.
3. *Strike fund benefits.* Strike fund benefits may be compensation to members, and may be wages subject to FICA, FUTA, and federal income tax withholding. Lockout benefits and lost time payments are treated, for these purposes, the same as strike fund benefits.
4. *Political campaign activities.* The examiner will ascertain whether the exempt labor organization engages in any political campaign activity, has paid any tax on its political expenditures, and/or maintains a separate segregated fund to engage in campaign activity (including voter education and registration efforts).[62]
5. *Other issues.* Other federal tax issues involving exempt labor organizations include engagement in legislative activities,[63] disclosure of nondeductibility of dues,[64] and the unrelated business rules (particularly associate member dues and commercial advertising).[65]

(l) Agricultural and Horticultural Organizations

Federal income tax exemption is available for agricultural and horticultural organizations, which are associations of persons who have combined to promote the interests of those engaged in raising livestock, harvesting crops or aquatic resources, cultivating useful or ornamental plants, and similar pursuits.[66] The issues to be reviewed by IRS examiners include the following:

1. *Membership requirements.* The examiner will review the membership requirements, including any classes of members, looking to detect the involvement of any persons who are not seeking to better the conditions of those engaged in agricultural or horticultural pursuits.

[60]See *id*. at II D.
[61]The guidelines state that ''[u]nderreporting of compensation has been an issue in many examinations of labor organizations.''
[62]See App. C § IV E.
[63]See *id*. at § III D.
[64]See *id*. at § XIV D.
[65]See *id*. at § IX D. IRM 4.76.14.
[66]See App. C § I L.

2. *Private inurement.* The private inurement doctrine[67] is applicable to tax-exempt agricultural and horticultural organizations. The provision of welfare, aid, and/or other financial assistance to employees or members of these organizations may constitute private inurement, as may use of the organizations' facilities for nonexempt purposes.
3. *Unrelated business.* The guidelines state that these organizations ''frequently'' have unrelated business income, from sources such as rental of debt-financed property, winter storage fees, commercial advertising, and provision of goods and services.
4. *Lobbying.* The examiner will determine whether the agricultural or horticultural organization is engaged in attempts to influence legislation that is not germane to the organization's exempt purposes. Also likely to be reviewed is whether any officials of the organization are registered lobbyists. These organizations may be subject to certain reporting requirements as to their lobbying activities.[68]
5. *Political campaign activities.* The examiner will ascertain whether the exempt agricultural or horticultural organization engages in any political campaign activity, has paid any tax on its political expenditures, and/or maintains a separate segregated fund to engage in campaign activity (including voter education and registration efforts).[69]

(m) Business Leagues

Federal income tax exemption is available for organizations that are organized and operated to promote the common business interests of their members.[70] The issues to be reviewed by an IRS examiner in this context include the following:

1. *Membership requirements.* The examiner will review the organization's membership requirements and any classes of membership, to determine if the members have a common business interest and represent a line of business.
2. *Private inurement.* The examiner will identify the types of compensation (including bonuses and expense reimbursements pursuant to accountable and nonaccountable plans) and benefits provided to the organization's employees, officers, and members, as well as the reason for other payments to members.[71]

[67]See *id*. at II D.
[68]See *id*. § III D.
[69]IRM 4.76.14 § 4.
[70]See App. C § I M.
[71]The guidelines state that the ''underreporting of compensation is a common problem encountered when examining tax-exempt business leagues.''

3. *Unrelated business.* Unrelated business activities of tax-exempt business leagues that will be reviewed by an IRS examiner include commercial advertising, certain management fees, sales of forms to members, certain associate member dues, and particular or individualized services.
4. *Legislative activities.* The examiner will ascertain whether any lobbying done by or on behalf of the tax-exempt business league is germane to the accomplishment of its exempt purposes. Also to be reviewed is the organization's compliance with the notice requirements and payment of a proxy tax.[72] Contracts with outside lobbyists will be examined.
5. *Political campaign activities.* The examiner will review the political campaign activities of a business league, including compliance with notice requirements and proxy tax rules, payment of tax on political expenditures, and use of any separate segregated fund.[73]

(n) Social and Recreational Clubs

Qualifying social and recreational clubs are exempt from federal income tax; these entities include country clubs, sports clubs, hobby clubs, and college and university fraternities and sororities.[74] The issues that will arise in the context of an IRS examination of one of these clubs include the following:

1. *Operational considerations.* The IRS will determine whether, as required for tax exemption, the members are bound together by a common objective directed toward pleasure, recreation, or similar purposes, and whether the organization's activities are in furtherance of these purposes. A key element is that there must be opportunities for commingling and other forms of personal contact. In general, an exempt club cannot have a written policy of discrimination on the basis of race, color, or religion.
2. *Income limitations.* In general, to be exempt, no more than 35 percent of a social club's gross receipts can constitute investment and other forms of nonmember income. Within that limit, generally no more than 15 percent of an exempt club's gross receipts can be derived from nonmember use of the club's facilities. The examiner will determine whether the club has complied with these limitations.
3. *Public use of facilities.* The examiner will scrutinize the club's premises, looking for evidence of public patronization of its facilities or functions, such as signage, admittance procedures, membership criteria, the terms of a liquor or gaming license, contracts with taxable entities (including

[72]See App. C § III C.
[73]IRM 4.76.15.
[74]See App. C § I N.

management contracts), initiation charges and dues, and advertising. Also to be examined are situations where nonmembers who use a club's facilities are deemed to be guests of members (*host–guests relationships*), including compliance with the recordkeeping requirements.

4. *Private inurement.* The private inurement doctrine is applicable to exempt social clubs, so the examiner will review the compensation of the club manager and officers, looking for elements such as bonuses and distributions of gross or net profit. The examiner should, in an instance of classes of membership, determine whether nonvoting members pay disproportionately more for services or benefits or otherwise if a class of membership is favored.
5. *Loss offsets.* Nonexempt membership organizations are not allowed to offset losses from membership activities against income derived from investments or other nonmember sources (in an effort to produce little or no taxable income).[75] The examiner should discuss the impact of this rule with a club in situations where the club is trying to convert to taxable status or where revocation of exemption is being contemplated.[76]
6. *Nontraditional business activities.* The examiner will ascertain whether the club is engaged in activities that are not in furtherance of a social club's exempt purposes (known as *nontraditional business activities*). These business activities include sale of package liquor, long-term rental of rooms, takeout and catering activities, commuter use of parking facilities, operation of a barber shop, and advertising. Conduct of these activities, other than in an incidental manner, may lead to revocation of a club's tax exemption.
7. *Unrelated business income.* The rules for tax-exempt social clubs as to computation of unrelated business income are different than the rules for exempt organizations generally; unrelated business income for exempt clubs is all gross income other than exempt function (membership-based) income.[77] The examiner, of course, will review the nature and extent of the club's income and determine whether it is related to the organization's exempt purpose. Again, non-member income and income from nontraditional business activities can be unrelated business income.

[75]See App. C § XII C.

[76]This loss offset limitation is not well-known law. A membership organization, such as a social club (or a social welfare organization (see § 7.1(i)) or a business league (see § 7.1(m)), may be of the view that, from a taxation standpoint, it is preferable for the organization to be nonexempt, on the assumption that the organization will have less or no tax liability because all losses can be utilized, when in fact the loss offset limitation precludes that outcome. Thus the guidelines require the IRS examiner to discuss this matter with the club, before an agreement as to revocation of exemption is secured, to be certain that club management understands the repercussions of this loss offset limitation.

[77]See App. C § IX F.

8. *Expense allocations.* An exempt club can use any method to allocate expenses that have a proximate and primary relationship to the unrelated business income against which they are allocated. Generally, there are three categories of expenses (direct, variable, and fixed) and different allocation methodologies. The examiner will review the method used to allocate expenses to member and nonmember income to determine both accuracy and reasonableness.
9. *Set-asides.* A tax-exempt social club can set aside investment income for charitable purposes; this set-aside income is not taxable as unrelated business income.[78] The examiner will review the nature of the set-aside, ensure that the income is eligible for a set-aside, determine whether the set-aside was timely, determine whether the set-aside purposes are charitable, and ascertain whether amounts set aside are subsequently used for noncharitable purposes.
10. *Other issues.* The examiner will determine if the exempt social club is properly paying employment taxes, if the service-based exception is available,[79] and if the rules as to tip income are being followed.[80]

(o) Fraternal Societies

Federal income tax exemption is available for fraternal societies operating under the lodge system; some of these entities provide life, sick, accident, and other benefits to their members and their dependents, and some of them devote their net earnings to charitable purposes.[81] Issues that arise when the IRS examines these organizations include the following:

1. *Lodge system.* The examiner will review the organizational documents of the exempt society to determine if it has rules governing subordinate lodges and the organizational documents of lodges to ascertain whether they are recognized as subordinates of a parent organization. Also, the examiner will review various documents to determine whether the parent and subordinate entities are active.
2. *Membership requirements and activities.* The examiner will endeavor to ascertain whether the members of a tax-exempt fraternal society have the requisite common fraternal bond. This will include the reason for more than one class of members, if applicable. The examiner will determine whether the organization is primarily engaged in fraternal activities.[82]

[78]See *id*.
[79]See *id*. § XII B.
[80]IRM 4.76.16.
[81]See App. C § I O.
[82]This is an area where exemption modification by the IRS (see § 5.33(f)) can be rampant (by application of the primary purpose rule (see App. C § II C)). Not only may an IRS examiner seek

3. *Payment of benefits.* In the case of a tax-exempt fraternal society that pays benefits to its members or their dependents (a *fraternal beneficiary society*), the examiner will determine the type of benefits provided, eligibility requirements for the benefits, the existence and purpose of any non-beneficial membership classes, and the ratio of beneficial members to non-beneficial members.[83]
4. *Unrelated business.* The guidelines state that fraternal organizations ''frequently'' have unrelated business income from sources such as bar and restaurant sales to the public, rental of debt-financed property to non-members, rental of facilities including the provision of services (such as food and beverage sales), gaming activities open to the public, and advertising. The examiner will review these activities and may consider revocation of tax exemption if these activities are substantial.
5. *Other issues.* Other issues that may arise in this context are compliance with the employment tax rules (including information reporting), use of related entities, and utilization of separate segregated funds for charitable giving purposes.[84]

(p) Voluntary Employees' Beneficiary Associations

Federal income tax exemption is available for qualified voluntary employees' beneficiary associations.[85] An IRS examination of one of these organizations will focus on the following nine issues:

1. *Organizational requirements.* The examiner will review the organizational document, and any amendments to it, seeking answers to questions such as whether the association is a separate legal entity, any provision made for the distribution of assets on its termination, control of the organization, the requisite employment-related common bond, eligibility requirements, and the nature of the benefits provided.
2. *Activities.* Substantially all of these organizations' activities must be in furtherance of the provision of permissible benefits. The examiner will review the summary plan description, any amendments to the plan, and any IRS rulings received subsequent to the receipt of recognition of exemption. The examiner will also review any contracts with insurance companies that provide benefits to members to ensure that the insurance

to change the basis for exemption from IRC § 501(c)(8) to IRC § 501(c)(10) (such as because of lack of payment of benefits) or the reverse, the examiner may endeavor to change the basis for exemption to IRC § 501(c)(4) (see § 7.1(j)) or IRC § 501(c)(7) (see § 7.1(n)).

[83]If the number of non-beneficial members is substantial in comparison to the beneficial members, the organization may not qualify for tax exemption as a fraternal beneficiary society.

[84]IRM 4.76.17.

[85]See App. C § I P.

policy is in the name of the organization (and not the employer) and that only permissible benefits are being provided.

3. *Membership.* Because membership in these associations is generally restricted to employees with an employment-related common bond (such as a common employer or coverage under a collective bargaining agreement), the IRS examiner will verify that membership is voluntary, at least 90 percent of the membership constitutes employees, members share the requisite common bond, and any nonemployee members share an employment-related bond with employee members.
4. *Benefits.* The IRS examiner will determine if the organization is providing permissible benefits or impermissible benefits (including impermissible benefits disguised as permissible benefits, such as severance benefits). The examiner will review benefits funded at least in part by employee contributions when individual accounts are maintained (looking for savings arrangements) and individual accounts funded at least in part by employer contributions (looking for pension or deferred compensation arrangements). Particular attention will be accorded benefits added to the plan subsequent to recognition of the organization's tax exemption.
5. *Discrimination.* In general, these plans must be nondiscriminatory as to eligibility and benefits; it is discrimination in favor of highly compensated employees that is prohibited. The examiner will conduct an employee census, reviewing matters such as annual compensation, length of service, whether the individual is an officer or shareholder of the employer, and any requirement as to employee contributions. Attention will be given to plans providing group-term life insurance and self-funded medical coverage.
6. *Recordkeeping.* The examiner will review the appropriate documents to determine whether the organization's records properly reflect the amount contributed by each member and employer, and the amount and type of benefits paid to or on behalf of each member.
7. *Types of plans.* The examiner will utilize additional examination techniques when reviewing plans such as multiple employer plans, collectively bargained plans, and limited membership plans.
8. *Unrelated business.* The examiner, in pursuing any unrelated business income, will differentiate between investment income (that can be set aside) and income from an unrelated business that is regularly carried on. The examiner will identify total organization assets at the end of the tax year and determine the account limit on reserves for benefits.
9. *Filing checks.* In addition to determining the nature of the benefits provided and whether any benefits other than those referenced in the plan document are being paid, the examiner will determine whether

the benefits are taxable for FICA, FUTA, or income tax purposes; determine whether any taxable benefits were correctly reported on Forms W-2, W-3, 940, 941, or 1099; and determine if the payments made by the employer are deductible. If taxable benefits were not correctly reported, the examiner will consider expansion of the scope of the examination to include the employment tax returns, secure any delinquent information returns, and consider whether discrepancy adjustments are appropriate.[86]

(q) Teachers' Retirement Fund Associations

Federal income tax exemption is available for teachers' retirement associations.[87] The IRS examiner will determine if the association's activities are confined to a territorial unit that is local in character, and if memberships other than of teachers are only incidental and confined to school employees. The examiner will also determine if the association's income is from permissible sources (amounts received from public taxation, amounts received from assessments on the salaries of members, and investment income) or from impermissible sources (such as conduct of a business). The private inurement doctrine is applicable in this setting.[88]

(r) Mutual and Cooperative Organizations

Federal tax exemption is available for benevolent life insurance associations and similar organizations of purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone and electric companies, and like organizations.[89] The purpose of these organizations is to provide certain services to their members at the lowest possible cost. An IRS examiner will address the following four issues:

1. *Operation as cooperative.* The IRS examiner will determine if the organization's operations comport with cooperative principles. This means, in part, that the cooperative must equitably allocate costs or savings among its member-patrons of each service so that savings or losses are returned to each member in direct proportion to the member's patronage. The agent will, for example, ascertain whether the cooperative has properly combined two or more services for allocation purposes. Also to be reviewed is issuance of nonvoting, interest-bearing stock to determine if the issuance is inconsistent with cooperative principles (by violating the subordination of capital principle). The examiner will

[86]IRM 4.76.18.
[87]See App. C § I Q.
[88]IRM 4.76.19.
[89]See App. C § I R.

review the organization's governing instruments to determine if they satisfy a cooperative's organizational and operational requirements.

2. *Activities test.* The examiner will, in the case of a benevolent life insurance association, determine if it is of ''purely local character.'' If the entity examined is a mutual ditch or irrigation company, the examiner will determine if the activities consist of bringing, channeling, or controlling water to or away from land. The examiner may be required to ascertain whether an activity or entity is a *like* activity or entity. Many tax-exempt cooperatives have expanded the scope of their services; the examiner will determine if the newer services are exempt functions.
3. *Member income test.* The examiner will determine if the organization derives, as is required, at least 85 percent of its income from its members. This will entail a determination as to what is *income* in this context; the law is replete with items that are excluded from this calculation (such as income from qualified pole rentals and income received by a wholly owned entity). The guidelines detail types of income in this regard and the effect of various accounting methods on the calculation. This test is applied independently of the activities test (above) and the unrelated business rules (below).
4. *Unrelated business.* These cooperatives are subject to the unrelated business rules. (Unrelated income is usually nonmember income for purposes of the 85 percent member-income test (above); nonmember income, however, is not necessarily unrelated business income.) Unrelated business income in this context includes advertising income, income from debt-financed property, depreciation recapture, and income from controlled organizations.

This is an area where the IRS examiner is likely to conclude that examination of an entity not under the jurisdiction of TE/GE Examinations is warranted; assistance from other agency functions may be requested.[90] Specialists that may be brought in for this purpose include those focusing on the utilities industry, the communications industry, voluntary employees' beneficiary associations,[91] computer audits, engineering,[92] excise taxes, and employee plans.[93]

[90]This referral request process is facilitated by the IRS's Specialist Referral System; a request online notifies the appropriate field specialist manager of the request, who can then assign an examiner to the project.
[91]See § 7.1(p).
[92]All annual information returns of cooperatives with assets of $10 million or more must be referred by the examiner for what the guidelines term ''engineering action.''
[93]IRM 4.76.20.

(s) Cemetery Companies

Federal income tax exemption is provided nonprofit cemetery companies that are owned and operated exclusively for the benefit of their members and other nonprofit cemetery companies and crematoria chartered solely for the purposes of burial or cremation.[94] An IRS examination will endeavor to determine if the organization is permitted to or is engaging in activities outside the bounds of what is permitted (such as operation of a mortuary) and, in the case of a mutual cemetery company, the organization is owned and operated exclusively for the benefit of its members (lot owners). Other matters that will be reviewed are operation of perpetual care organizations, sales of land (where there may be hidden profit distributions), eligibility of contributions for the charitable contribution deduction,[95] and application of the private inurement doctrine.[96]

(t) Credit Unions

Federal income tax exemption is available for credit unions that are organized and operated for mutual purposes (principally encouraging thrift by and providing credit to its members) and without profit.[97] The focus of an IRS examination of a tax-exempt credit union is whether the credit union is operated for mutual purposes and is in compliance with state law. The examiner will determine membership requirements and ascertain whether the organization has a written, enforced common bond among its members. Other issues to be resolved are application of the private inurement doctrine (with the examiner looking for matters such as stock certificates and write-offs of loans to officers) and the unrelated business rules (such as advertising income and rental income from debt-financed property).[98]

(u) Small Insurance Companies

Federal income tax exemption is available for property and casualty insurance companies with annual gross receipts not in excess of $600,000 and where more than 50 percent of these receipts consists of premiums. In the case of a mutual insurance company, the corresponding limitations are $150,000 and 35 percent.[99] The IRS examiner will thus determine if the organization's activities are primarily the issuance of insurance, if the organization is an

[94]See App. C § I S.
[95]See *id*. § XIII A. For example, a contribution for the perpetual care of a particular lot or crypt, rather than for a cemetery as a whole, is not deductible; a payment for a burial lot or crypt is not a contribution.
[96]IRM 4.76.21.
[97]See App. C § I T.
[98]IRM 4.76.22.
[99]See App. C § I U.

insurance company, and whether the gross receipts tests are met. As to the third of these elements, the examiner will determine whether the insurance company is a member of a controlled group. The examiner will also review transactions between related parties to determine whether a ''significant tax avoidance effect exists or if the transactions indicate a 'sham.''' Also to be ascertained is whether the insurance company is a captive foreign corporation and whether the organization has made the ''U.S. assets test'' election. Insurance companies in liquidation that no longer receive premiums, with their main source of income being investment income, may nonetheless qualify for this tax exemption if they meet a transitional rule for companies in receivership or liquidation; the examiner will inquire as to adherence to this rule.[100]

(v) Crop Financing Organizations

Federal income tax exemption is provided for corporations that are organized by an exempt farmers' cooperative marketing or purchasing association[101] for the purpose of financing the ordinary crop operations of members or other producers.[102] The IRS examiner will verify whether the organizing association is tax-exempt and, if so, whether the association or its members hold substantially all of the voting stock of the financing organization. The examiner will verify that the dividend rate on stocks does not exceed the greater of the legal rate of interest in the state of incorporation or 8 percent per annum on the value of the consideration for which the stock was issued. The examiner will also determine the purpose of, the necessity for, and the reasonableness of reserves.[103]

(w) Supplemental Unemployment Benefit Trusts

Federal income tax exemption is available for a trust or trusts forming part of a plan providing for the payment of supplemental unemployment compensation benefits to employees.[104] The examiner will thus determine whether the purpose of the trust in fact is to provide other forms of benefits, such as sick and accident benefits (which are allowable if incidental). The examiner will also inquire as to whether the trust is providing death, vacation, or retirement benefits (which are impermissible). The examiner will also verify the bases on which unemployment benefits are provided, inasmuch as they can only be paid in the event of an employee's involuntary separation from employment (due to circumstances such as a reduction in workforce or discontinuance of an operation). Supplemental unemployment benefit plans must meet certain

[100]IRM 4.76.23.
[101]See App. C § I V.
[102]See App. C § I V.
[103]IRM 4.76.24.
[104]See App. C § I W.

nondiscrimination requirements and must not engage in certain prohibited transactions; the examiner will ascertain whether these requirements are being satisfied and transactions avoided. Sources of income, particularly income not from members, employers, or investments, will be reviewed in search of unrelated business income.[105]

(x) Veterans' Organizations

Federal exemption from income tax is provided for an organization of past or present members of the U.S. armed forces, or an auxiliary unit or society of or trust or foundation for, any such organization.[106] An IRS examination will focus on the following three issues:

1. *Membership requirements.* Percentage limitations are used to determine whether a veterans' organization qualifies for tax exemption.[107] Thus, an IRS examiner will review the appropriate documents to determine the composition of the organization's membership and its compliance with these membership requirements. The guidelines state that it is ''very important'' for the examiner to analyze the dues structure, rights, and responsibilities of membership, looking for situations where members have ''privileges similar to the general public utilizing entertainment facilities and goods and services of the organization.'' Thus, nonmember participation can lead to revocation of exempt status.[108]
2. *Deductibility of contributions.* Contributions to a veterans' organization may be deductible as charitable gifts.[109] These donee organizations, however, must meet the *war veterans* membership requirement, so the IRS examiner will ascertain compliance with that rule, which also requires a determination as to whether veterans served during a *period of war*.
3. *Auxiliary units.* A veterans' organization may have an auxiliary unit or society. The examiner will ascertain whether that unit is part (what the guidelines term a ''function'') of the organization, a separate tax-exempt organization, or a separate nonexempt entity. If it is a separate exempt

[105]IRM 4.76.25.

[106]See App. C § I X.

[107]These include the rule that at least 75 percent of the organization's members must be present or former members of the U.S. armed forces and that 90 percent of the remaining 25 percent must be students in a college or university ROTC program or at an armed services academy or be spouses, widows, or widowers of such persons.

[108]A veterans' organization that does not meet these membership requirements may find that the IRS examiner will propose modification of exemption (see § 5.33(e), (f)) to that of a social welfare organization (see § 7.1(i)). Indeed, in some instances, these organizations qualify as social clubs (see § 7.1(n)), fraternal organizations (see § 7.1(o)), or charitable and educational entities (see § 7.1(b)).

[109]See App. C § XIII A.

organization, the examiner will review its operations in accordance with the applicable exempt organizations law generally.

4. *Recordkeeping requirements.* The examiner will determine whether the organization is maintaining adequate records to distinguish between members and nonmembers who participate in its activities, and the amount of income derived from each category (principally in search of unrelated business income). This includes a determination as to whether an individual is a *guest* of a member. Failure to maintain adequate records may lead to revocation of exempt status.
5. *Unrelated business.* The examiner, in an effort to find unrelated business conducted by an exempt veterans' organization, will ascertain whether the organization is engaging in activities such as rental of facilities to the public, opening bar and dining facilities to the public, selling food and/or liquor to members and/or the public for off-premises consumption, and gaming with nonmembers. (Unrelated business income does not include any amount attributable to payments of life, sick, accident, or health insurance with respect to members or their dependents, that is set aside for the purpose of providing for the payment of insurance benefits or a charitable purpose.)[110]

(y) Black Lung Benefit Trusts

Federal income taxation is available for qualifying black lung disease (pneumoconiosis) benefit trusts.[111] The IRS examiner will determine whether the entity was properly formed, looking to see if an insurance company established it (which is impermissible), and operated.[112] The examiner will ascertain whether the trust has any unusual sources of income (namely, income from a source other than the employer or permitted investments) or unusual disbursements (namely, expenditures for purposes other than benefits payments and administration). The benefit payments will be tested to determine if they are impermissible benefits (namely, benefit payments unrelated to black lung disease, such as worker compensation for an injury sustained because of a coal mine accident). The examiner will look to see if the trust's assets are only invested in permitted investments, such as obligations of the U.S. and/or one or more states, and/or time or demand deposits in a domestic bank or credit union. The examiner will also determine if the trust may be subject to excise taxes for self-dealing and/or taxable expenditures.[113]

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[110]IRM 4.76.26.
[111]See App. C § I Y.
[112]An insurance company can, however, be contracted with for the payment of benefits.
[113]IRM 4.76.27.

(z) Multi-Parent Title-Holding Organizations

Federal income tax exemption is available for qualified multi-parent title-holding corporations or trusts.[114] The examiner will thus ascertain whether the requirements are satisfied, which include a maximum of 35 shareholders or beneficiaries, only one class of stock or beneficial interest, and operation for the exclusive purposes of acquiring, holding title to, and collecting income from real property and remitting the net income to eligible shareholders or beneficiaries. The examiner will also explore the eligibility of the shareholders or beneficiaries (such as by researching IDRS) and whether property other than real property is being held. The examiner will further analyze compliance with the shareholder or beneficiary requirements, such as those pertaining to control, dismissal of the investment advisor, and termination of interest in the corporation or trust. The examiner will inspect all sources of income in search of unrelated business income.[115] This type of tax-exempt organization may own one or more qualified subsidiaries; the examiner will explore compliance with these rules.[116]

(aa) Apostolic Organizations

Federal income tax exemption is available for apostolic organizations.[117] The principal focus of an examination of these entities will be on the operational requirements, which include functioning as a communal religious community, surrendering of property to the organization by its members, farming or manufacturing as the primary activity, and a community treasury. These organizations have unusual filing responsibilities, which the examiner will explore, in that they file a partnership return (Form 1065) rather than a conventional annual information return;[118] the members report their pro rata share of the organization's income as a dividend on their individual tax returns (irrespective of whether the income is distributed).[119]

(bb) Political Organizations

Federal income tax exemption is provided for political organizations.[120] These entities are political parties, committees, associations, funds, or other organizations that are organized and operated primarily for the purpose of accepting contributions and making expenditures for an exempt function.

[114]See App. C § I Z.
[115]A multi-parent title-holding entity can receive, without endangering its exemption, unrelated business income in an amount up to 10 percent of its gross income, as long as the unrelated income is incidentally derived from the holding of real property.
[116]IRM 4.76.28.
[117]See App. C § I AA.
[118]See *id*. § VII E.
[119]IRM 4.76.29.
[120]See App. C § I BB.

Thus, the IRS examiner will determine whether the entity is properly organized[121] and is engaging in one or more *exempt functions*, which usually are activities directly related to and supportive of the process of influencing or attempting to influence the selection, nomination, election, or appointment of an individual to a federal, state, or local public office.[122] The examiner will ascertain the extent to which the organization is receiving exempt function income (such as contributions, proceeds from fundraising events, and conduct of legal bingo games[123]) and is making nonexempt function expenditures (such as for attempts to influence legislation or voter registration drives or other nonpartisan activities). Because political organizations are taxed on their nonexempt function income (such as investment income), the examiner will also ascertain whether any of this tax has been properly computed. The examiner will also determine if the organization has provided adequate notice to the IRS that it is a political organization (Form 8871), is making the requisite disclosure of contributions and expenditures (Form 8872), and filing the requisite annual returns (Form 990, 1120-POL).

Some tax-exempt organizations, particularly social welfare organizations,[124] labor organizations,[125] and business leagues,[126] create separate segregated funds for the purpose of making political expenditures.[127] The IRS examiner will determine if these funds qualify as exempt political organizations and if funds distributed from an exempt organization to a political organization are transferred on a timely basis.[128]

(cc) Health Maintenance Organizations

Health maintenance organizations directly provide or arrange for the provision of healthcare services to members on a prepaid basis typically through a managed care arrangement.[129] In some instances, these organizations can be federally tax-exempt as charitable entities[130] or social welfare organizations (either on their own or as an integral part of an exempt healthcare system).[131] As to organizations that claim to be exempt charitable health maintenance organizations, the IRS examiner will review the persons enrolled in the program(s)

[121]This requirement is not particularly difficult to satisfy, inasmuch as a mere bank account can qualify.
[122]An *exempt function* may also include influencing the election of presidential or vice-presidential electors.
[123]See App. C § XII A.
[124]See § 7.1(i).
[125]See § 7.1(k).
[126]See § 7.1(m).
[127]This is done, *inter alia*, to avoid taxation of political expenditures (see App. C §§ I BB, IV A) and to comply with the federal election law (see *Tax-Exempt Organizations* § 23.11).
[128]IRM 4.76.30.
[129]See *Tax-Exempt Healthcare Organizations* § 9.2; *Tax-Exempt Organizations* § 7.6(e).
[130]See § 7.1(I B).
[131]See § 7.1(I I).

(such as individuals who are unable to obtain affordable healthcare services or insurance), the method the organization uses to determine the premiums it charges the members, and the extent to which the organization is controlled by community interests; the examiner will also determine whether the organization qualifies as a Medicaid health maintenance organization. Similar criteria are used to determine whether the health maintenance organization qualifies as a social welfare organization, although the emphasis in this context is on promoting the common good and general welfare of the community rather than promoting health or relief of the poor or the distressed. The examiner will also ascertain whether the organization is providing commercial-type insurance, which will be an unrelated business or an activity warranting revocation of exempt status.[132]

§ 7.2 PUBLIC CHARITY AND PRIVATE FOUNDATION STATUS

The IRS's tax-exempt organization's examination guidelines, concerning the public charity and private foundation rules, are devoted largely to a summary of these rules.[133] Nonetheless, the IRS examiners are provided considerable pointed guidance as to the questions to ask.

(a) Donative Publicly Supported Organizations Issues

Here are the areas of inquiry an IRS examiner is likely to pursue in a review of a donative publicly supported charity:

- Identify unusual grants (or grants that do not so qualify) by reviewing documentation accompanying the grant (including material restrictions), minutes and other documents to determine if the grant came from a disinterested party, donor lists to determine if the organization continually relies on unusual grants for funding, and any ruling(s) from the IRS on the topic.
- Determine whether a revenue item is a contribution or a form of gross receipts.
- Determine if an item was paid to the organization as a government grant or payment pursuant to a government contract.
- Determine if an item is a contribution or a form of exempt function income.
- Ascertain whether a payment is a qualified sponsorship payment.
- Identify any unrelated business income.[134]

[132]IRM 4.76.31. See *Tax-Exempt Organizations* § 24.11.
[133]See App. C § V.
[134]IRM 4.76.3.5.5.

(b) Facts-and-Circumstances Test

The examiner is likely to inquire as to whether the organization is in compliance with the facts-and-circumstances test[135] (if the organization is relying on it) by asking questions such as the following:

- Does the organization receive financial support from a ''representative'' number of persons or from a single family?
- Are the organization's activities limited to a region or specialized field (that might limit the sources of support)?
- Does the organization's governing body represent broad interests of the public or private interests of a limited number of donors?
- Does the organization disseminate its programs, seminars, benefits, and the like to the public?
- Are facilities and services of the organization provided directly to the public on a continuous basis?
- Is the public familiar with the organization's mission?
- Does the organization receive a significant part of its funding from a public charity or governmental agency?[136]

(c) Service Provider Publicly Supported Organizations Issues

Here are the areas of inquiry an IRS examiner is likely to pursue in a review of a service provider publicly supported charity:

- Identify the extent of the organization's annual financial support from permitted sources.
- Identify persons that are disqualified persons with respect to the organization.
- Identify forms of revenue that do not constitute public support.
- Identify the amount of the organization's total support.
- Determine whether the $5,000 or 1 percent limitation is being correctly computed.
- Identify the organization's gross investment income.
- Identify the organization's unrelated business income.

Issues that an IRS examiner is likely to pursue include the following:

- Whether a revenue item is a contribution or a form of gross receipts

[135]See App. C § V C.

[136]Grants from these sources may not or will not be subject to the 2 percent limitation, thereby increasing the likelihood that the entity will qualify as a donative publicly supported organization. IRM 4.76.3.5.4.

- Whether a revenue item is a grant or a form of gross receipts[137]
- Whether a revenue item is a membership fee or form of gross receipts
- Identification of the organization's gross investment income
- Identification of the organization's unrelated business income[138]

(d) Supporting Organizations Issues

There are four types of supporting organizations:[139] those that are operated, supervised, or controlled by one or more qualified supported organizations (Type I entities); supervised or controlled in connection with one or more qualified supported organizations (Type II entities); operated in connection with and functionally integrated with one or more qualified supported organizations (Type III entities); and operated in connection with and not functionally integrated with one or more qualified supported organizations (also Type III entities). The issues pursued by an IRS examiner of a supporting organization will depend in part on the type of supporting organization involved.

On the occasion of an IRS examination of a supporting organization, the examiner is likely to pursue the following issues:[140]

- Qualification of each supported organization. This can be tricky because, although most supported organizations are other forms of public charities, there are other types of supported organizations, including supporting organizations that are ''described in'' one of the other classifications of public charity (usually one of the publicly supported charities), exempt social welfare organizations,[141] exempt labor organizations,[142] and exempt business leagues.[143]
- In the case of a Type I entity, the examiner will verify that at least a majority of the supported organization's board of directors is elected, appointed, or otherwise determined by the supported organization(s).
- In the case of a Type II entity, the examiner will verify that the supporting organization and the supported organization(s) are under common supervision and control.

[137]In an understatement, the examination guidelines alert the examiner to the possibility of ''misclassifications'' in this area.
[138]IRM 4.76.3.6.
[139]See App. C § V D.
[140]The examination guidelines have not been updated to include the law added by enactment of the Pension Protection Act of 2006; elements of this law are nonetheless incorporated in this section.
[141]See App. C § I I; § 7.1(i).
[142]See App. C § I K; § 7.1(k).
[143]See App. C § I M; § 7.1(m). There have been examinations where the examiner did not know that an entity other than a public charity may qualify as a supported organization. This may be in part because the examination guidelines do not address the topic.

- In the case of a Type III entity, the examiner will explore compliance with the responsiveness test and the integral part test. As to the former, the examiner will examine the composition, origins, and functions of the board of directors of the supporting organization. As to the latter, the guidelines summarize the four methods by which this test may be satisfied.
- In the case of a Type III entity, the examiner will ascertain whether the supporting organization's operations are functionally integrated with those of the supported organization(s).[144]
- The examiner will determine whether the supporting organization's governing instrument meets the appropriate organizational test.[145]
- The examiner will determine, where payments are being made to persons other than one or more supported organizations, the recipients of the payments are qualified beneficiaries.
- The examiner will determine whether the supporting organization is engaging in permissible activities (principally grant-making, discrete

[144]The contours of the definition of this concept are evolving. The IRS, on August 1, 2007, announced that it is expected that all Type III supporting organizations (see App. C § V D) will be required to meet the present-day *responsiveness test* (Reg. § 1.509(a)-4(i)(2)(ii)). Also, the agency announced that it is anticipating proposing rules concerning Type III supporting organizations, including a requirement that these organizations that are functionally integrated with one or more supported organizations meet (1) the existing *but for test* in the regulations (Reg. § 1.509(a)-4(i)(3)(ii)), (2) an expenditure test that will resemble the qualifying distributions test for private operating foundations (see *Tax-Exempt Organizations* § 12.1(b), text accompanied by notes 10-21), and (3) an assets test that will resemble the alternative assets test for operating foundations (*id*., text accompanied by notes 22, 25-28) (REG-155929-06). It is also expected that a Type III supporting organization that is not functionally integrated will be required to meet a payout requirement equal to the qualified distribution requirement imposed on standard grant-making private foundations (see *Tax-Exempt Organizations* § 12.4(b)). The proposed regulations may be expected to provide that certain Type III supporting organizations that oversee or facilitate the operation of an integrated system that includes one or more charities and that may be unable to satisfy certain requirements of the operating foundations' expenditure and assets test, such as certain hospital systems, will nonetheless be classified as functionally integrated entities in the proposed regulations if they satisfy the existing but for test. The IRS reiterated these proposed regulations on September 28, 2007 (Ann. 2007-87, 2007-40 I.R.B. 753).
The IRS, on December 6, 2006, issued interim guidance concerning supporting organizations and private foundation grants to them, including a definition of a functionally integrated Type III supporting organization on which foundation grantors may rely for purposes of pre-grant due diligence (Notice 2006-109, 2006-51 I.R.B. 1121). The agency announced, on February 22, 2007, that it had suspended issuance of determination letters where organizations are seeking recognition as a functionally integrated Type III supporting organization, pending issuance of guidance as to the meaning of that phrase (memorandum for the Manager, Exempt Organizations (EO) Determinations, from the Acting Director, EO Rulings and Agreements). As a consequence of the announcement of these proposed rules on August 1, 2007, the IRS announced, on September 24, 2007, that it lifted the suspension of issuance of determination letters in cases of functionally integrated Type III supporting organizations (memorandum for the Manager, EO Determinations, from the Director, EO Rulings and Agreements).

[145]Interestingly, the guidelines call for an application of this organizational test only after the examiner has established that one of the requisite operational relationships is in place.

programs (including endowments), fundraising, and unrelated business).

- The examiner will determine, in the case of a Type III entity, if the supporting organization is providing the requisite information to the supported organization(s) and verify that the supporting organization is not operating for the benefit of charitable organizations outside the United States.
- The examiner will ascertain whether the supporting organization has accepted a contribution from a person (other than a qualified supported organization) who, directly or indirectly, controls the governing body of a supported organization.
- The examiner will determine whether the private foundation excess business holdings rules[146] are (when applicable) being properly applied to the supporting organization.
- The examiner will determine whether the supporting organization has received a grant from a private foundation where the grantee is a type of supporting organization that cannot receive a qualifying distribution.[147]
- The examiner will determine whether disqualified persons[148] with respect to the supporting organization, directly or indirectly, control it.[149]

(e) Public Safety Organizations

Public charity status is available for organizations that are organized and operated exclusively for testing for public safety.[150] The guidelines recognize the fact that ''few'' of these exempt organizations are in being, either because they are not testing consumer products or are serving private interests.[151]

(f) Workpaper Documentation

The examination guidelines include the following workpaper documentation tasks for the examiner:

- If it is ''obvious'' to the examiner that the organization is publicly supported,[152] it is ''not usually necessary to make an in-depth public

[146]See App. C § V F.
[147]See *id*. § V D. A finding of a claim of an ineligible payout credit for a grant made to a supporting organization may cause the examiner to refer the private foundation for examination (or undertake the examination himself or herself).
[148]See App. C § V F.
[149]IRM 4.76.3.8.
[150]See App. C § V E.
[151]IRM 4.76.3.9.
[152]Examples provided of ''obviously'' publicly supported organizations are United Way entities and community orchestras, although the latter are not always clearly publicly supported.

support verification'' because any error in the computation is not likely to materially change the public support percentage. Nonetheless, the examiner is expected to create a workpaper showing that the foundation status was considered and the ''reason for reaching the stated conclusion.''

- Any change or modification of the then-existing public charity classification that the examiner proposes is considered adverse and treated as an unagreed case.[153] The examiner will attempt to procure an executed consent to the proposal (Form 6018) (knowing that the signed form is not binding but that it indicates the organization's position at the time).
- The examiner, in the case of a publicly supported organization, is encouraged to look not just at the support amounts for the year under examination but also other years to determine if it meets the aggregate support test or otherwise meets one or more special rules.
- If the examiner concludes that the organization is not a publicly supported entity under any of the tests, he or she is to give consideration to classification of the organization pursuant to another category of public charity, annotating the workpapers accordingly.
- The workpapers and any report should reflect that the IRS ''granted the organization the most advantageous foundation classification for which it qualifies.''[154]

(g) Private Foundations

The IRS's tax-exempt organizations examination guidelines do not include guidance for examiners of private foundations as to the special private foundation rules.[155] Nonetheless, an examiner reviewing the operations of a private foundation will:

- Review the foundation's governing instruments to determine if the organizational test for charitable organizations generally[156] and the special organizational test for private foundations is being satisfied.
- Ascertain whether any acts of self-dealing occurred during the examination period.
- Ascertain whether the appropriate amount of qualifying distributions were made during the examination period.

[153]See App. C § V C.
[154]IRM 4.76.3.10. The elements the IRS considers with respect to the types of publicly supported charities are summarized at IRM 4.76.3.7.
[155]See App. C § V F.
[156]See *id*. § II A.

- Ascertain whether the private foundation had any excess business holdings during the examination period.
- Determine whether the private foundation made any jeopardizing investments during the examination period.
- Determine whether the private foundation made any taxable expenditures during the examination period.
- Ascertain whether the private foundation calculated and paid the correct amount of excise tax on its net investment income.
- Determine if the private foundation timely and correctly filed annual information return(s) (Form 990-PF) during the examination period.[157]
- Determine if the private foundation is complying with the document disclosure and dissemination rules.[158]

(h) Other Issues

The examination guidelines remind the IRS examiners that, in the context of reviewing public charity and private foundation status, the organization needs to be reviewed from the standpoints of compliance with the operational test,[159] the doctrine of private inurement,[160] the doctrine of private benefit,[161] and the excess benefit transaction rules.[162] As to the latter, the importance of these rules has been increased as the consequence of legislation enacted in 2006, which grafted the concept of the *automatic excess benefit transaction* onto the supporting organizations rules.[163] The guidelines observe that ''[o]ne of the most difficult jobs for the examiner is to determine if an excess benefit transaction has occurred'' and that ''part of making the determination is to know the value of the transaction itself, which will tell the examiner if it is excessive or not.''[164]

Here are the following ''suggested audit steps'' the examiner may take to identify issues concerning private inurement, private benefit, and excess benefit transactions:

- Make a determination as to the insiders and/or disqualified persons with respect to the tax-exempt organization.

[157]See *id*. § VII A.
[158]See *id*. § VIII A.
[159]See *id*. § II B.
[160]See *id*. § II D.
[161]See *id*. § II E.
[162]See *id*. § II F.
[163]See *id*. § V D.
[164]This observation is equally applicable with respect to the doctrines of private inurement and private benefit. It may also be noted that merely ascertaining the ''value of the transaction'' does not always automatically lead to the basis for a conclusion that there is an element of ''excess'' in the facts; indeed, the guidelines elsewhere note that the examiner may want to consider a referral to Engineering to help determine the fair market value of an item of property.

- Carefully review the annual information return.
- Review the amount of compensation (including fringe benefits) paid to key employees and other insiders, including reconciliations with the Forms W-2.
- Review employment contracts, fundraising agreements, and compensation packages.
- Review disbursements.
- Review any sales or exchanges of property.
- Analyze the composition of the organization's assets.
- Determine the relationship between the organization and one or more other entities.[165]

The examination guidelines also raise, in this context, the issue of direct and grassroots lobbying conducted by tax-exempt public charities.[166] The examiner is expected to inquire as to whether the organization:

- Placed paid articles and advertisements in newspapers or magazines that promote the organization's legislative interests
- Engaged in commentaries through television, cable, radio, or other public communications
- Publicized or disseminated its position on certain legislation in articles or publications
- Made direct mailings or Internet campaigns that encourage the public to contact legislators regarding its position as to legislation
- Made grants to organizations engaged in legislative activities
- Compensated lobbyists directly or by means of intermediaries or other related organizations
- Paid dues to parent, state, or national organizations for legislative activities

The examiner will also ascertain whether the organization has elected the expenditure test and, if so, if it has properly calculated the lobbying amounts and any resulting taxes, and (if applicable) properly utilized any of the exceptions to the lobbying rules. If the organization has not made this election, the examiner will determine whether it has comported with the substantial part test and if the organization is liable for any excise taxes on lobbying expenditures.[167]

[165]IRM 4.76.3.11.
[166]See App. C § III A.
[167]IRM 4.76.3.12.

Also raised in this context are the rules, applicable to tax-exempt public charities, concerning political activities.[168] In this regard, the IRS examiner may:

- Review the organization's disbursements and canceled checks to determine possible payments to politicians, political parties, political action committees, ''bogus trade associations,'' and law firms for the benefit of political candidates.
- Review contracts involving the organization to determine possible lending or sharing of equipment for the benefit of political candidates.
- Read the organization's minutes and newsletters in search of references to political figures or political events.
- Peruse local newspapers for announcements regarding political events sponsored by the organization.
- Test expense reimbursements for any political contributions.
- Check supplier invoices for evidence of overbilling (where an excess amount may have been diverted for political purposes).
- Test payroll accounts for evidence of compensation of one or more employees who may have worked on political campaigns on the organization's time.

The examiner will also explore the possibility of assessment of the tax on political expenditures by charitable organizations, either in lieu of or in conjunction with revocation of tax exemption. The examiner will further analyze whether it may be necessary to make an immediate determination and assessment of income tax as to the charitable organization or seek a civil injunction, in an instance of a flagrant law violation, to prohibit further political expenditures by the charitable organization.[169]

§ 7.3 NONEXEMPT CHARITABLE TRUSTS AND SPLIT-INTEREST TRUSTS

The IRS's tax-exempt organizations examination guidelines provide brief guidance to examiners on the matter of reviews of nonexempt charitable trusts[170] and split-interest trusts (almost exclusively charitable remainder trusts).[171] The guidelines observe that the rules regarding these entities are

[168]See App. C § IV A.
[169]IRM 4.76.3.13.
[170]See App. C § XIII E.
[171]See *id*. § XIII D.

quite complex and are frequently misapplied or deliberately abused. Essentially, the private foundation rules[172] apply to nonexempt charitable trusts and split-interest trusts.

An examination of one of these trusts will have four objectives: a determination as to whether (1) the trust is operating in accordance with the applicable law, (2) the unexpired interests (in the case of a nonexempt charitable trust) or the remainder interest (in the case of a split-interest trust) are devoted to a charitable purpose, (3) any of the private foundation law provisions (including taxes) are applicable, and (4) a referral should be made to Exempt Organizations Examinations to consider income tax issues.

(a) Nonexempt Charitable Trusts

The examiner of a nonexempt charitable trust will:

- Determine if the trust is filing the appropriate annual returns (Forms 1041, and 990 or 990-PF).
- Verify that the trust has exclusively charitable interests or beneficiaries.
- Verify that the trust is an entity for which a charitable deduction was allowed.
- Ascertain whether the trust is or should be satisfying the organizational and operational rules applicable to supporting organizations.[173]
- Determine if the trust is liable for any of the private foundation excise taxes.
- Verify that the trust is properly calculating the excise tax on its net investment income.[174]

(b) Split-Interest Trusts

The examiner of a split-interest charitable trust will:

- Review the trust document to determine if all of the organizational requirements are satisfied.
- Review records concerning the nature of property transferred to the trust and the date that the transfer was legally accomplished.
- Determine if the trust is liable for any of the private foundation excise taxes.

[172]See *id*. § V F; § 7.2.
[173]See App. C § V D; § 7.2(d).
[174]IRM 4.76.5.1.3.

- Ascertain whether it is necessary to coordinate the examination in connection with an issue concerning the allowance of a charitable deduction for a gift made to the trust.[175]

(c) Abusive Trusts

Examiners are exhorted to ''pay special attention'' to trusts utilizing promoters who market potential abusive tax schemes. Thus, documents relating to the ''marketing scheme'' should be reviewed and consideration should be given to coordination of this examination with others within the IRS.[176] The examiner is expected to accord ''special interest'' to trusts operating with a multi-tier system for tax avoidance purposes, by determining the other entities with which the trust is involved,[177] how these entities are interrelated with the trust, and determine if distributions are being made to another entity in which the donor-creator receives the ultimate benefit.

The examiner will check to see if the creator of a nonexempt charitable trust assigns or redirects income to the trust, never giving up control of the income or assets. The examiner may determine that the trust is a sham or a grantor trust, resulting in employment tax issues. Also, the examiner will verify that the nonexempt charitable trust is not paying the personal expenses of the creator or trustee, and labeling these expenses as ''management service fees.''

An examiner of a charitable remainder trust will have several issues to review (including the organizational test, the property contributed to the trust and its value, calculation of the charitable deduction, and determination of any unrelated business income[178]), but one issue of particular interest to the IRS is prearranged sales of highly appreciated property that are structured in an effort to avoid capital gain taxes.[179] If there is no economic purpose to the transaction (other than tax avoidance) and the grantor effectively retains control over the asset(s), the examiner will consider treating the arrangement as a sham transaction or a transaction giving rise to a grantor trust.[180]

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[175]This coordination thus will be between an Exempt Organizations Examiner and an examiner from the Small Business/Self-Employed (SB/SE) Division. IRM 4.76.5.1.4.

[176]The guidelines reference the possibility of contacting the SB/SE Division's Abusive Tax Promoters Group. The examination guidelines have not been updated to incorporate applicability of the laws enacted in 2005 concerning the involvement of tax-exempt organizations in tax shelters (see *Tax-Exempt Organizations* § 27.15(j)).

[177]The examination will likely perform Integrated Data Retrieval System research for this purpose.

[178]An excise tax is applied to unrelated business taxable income received by a charitable remainder trust (IRC § 664(c)(2)) (see *Charitable Giving* § 12.7 (2007 Cum. Supp.)). Previously, the receipt of this type of income caused the trust to lose its tax-exempt status for the year involved.

[179]By application of the step transaction doctrine (see *Charitable Giving* § 4.8), the capital gain in these transactions may be taxable to the donor.

[180]IRM 4.76.5.1.5.

§ 7.4 UNRELATED BUSINESS ACTIVITIES

The IRS's tax-exempt organizations examination guidelines do not separately include guidance as to exempt organizations' compliance with the unrelated business rules.[181] Rather, the guidelines intersperse this guidance throughout the various sections of the guidelines.[182] Nonetheless, as to this aspect of the law, the examiner will (or should):

- Determine whether a particular activity constitutes a business.
- Determine whether a business is regularly carried on.
- Determine whether a business is related to the organization's exempt purpose(s).
- Determine whether a business is substantially related to the organization's exempt purpose(s).
- Ascertain the applicability of one or more exceptions, from the unrelated business rules, with respect to the organization's activities.
- Ascertain the applicability of one or more exceptions, from the unrelated business rules, with respect to the organization's income.
- Review the computation of the special rules pertaining to unrelated business income of entities such as social clubs.
- Determine if the organization is accurately reporting its unrelated business activity on its annual information return(s) (e.g., Form 990 or 990-EZ).
- Determine if the organization is (if required to do so) accurately reporting its unrelated business activity on an unrelated business income return (Form 990-T) (and properly making that return publicly available).

§ 7.5 REPORTING REQUIREMENTS

The IRS's tax-exempt organizations examination guidelines do not separately include guidance as to exempt organizations' compliance with the annual information return filing rules.[183] Rather, the guidelines intersperse this guidance throughout the various sections of the guidelines.[184]

[181]See App. C § IX.
[182]See, e.g., §§ 7.1(a) § 7, 7.1(b) § 10, 7.1(d) § 2, 7.1(i) § 5, 7.1(j) § 4, 7.1(k) § 5, 7.1(l) § 3, 7.1(m) § 3, 7.1(n) § 7, 7.1(o) § 4, 7.1(p) § 8, 7.1(r) § 4, 7.1(x) § 5.
[183]See App. C § VII A.
[184]See, e.g., §§ 7.1(e) § 2, (bb).

§ 7.6 FUNDRAISING

The IRS's tax-exempt organizations examination guidelines address the matter of fundraising. Not surprisingly, the guidelines focus on the operations of exempt organizations to which deductible contributions may be made.

(a) Advertisements of Fundraising Activities

The IRS has long been concerned with situations where tax-exempt organizations, to which deductible contributions may be made, have advised potential contributors that the entire amount paid to attend events, to purchase tickets to events, or for other privileges or benefits in connection with fundraising events is fully tax-deductible when in fact only a portion of the payment (or perhaps none of it) is properly deductible. Certain disclosure rules are applicable in this regard to these types of charitable and other exempt entities.[185]

Thus, an IRS examiner will determine if any fundraising activities were designed to solicit payments intended in part as a gift and in part as the purchase price paid for participation in an event. Examples of these types of events are charity balls, bazaars, banquets, shows, and athletic events. The examiner will review the organization's solicitation materials and activities to determine if the organization clearly designated the amount of the payment that was attributable to purchase of admission or other privilege and the portion that was deductible as a charitable contribution. The examiner will inspect tickets or receipts issued to the patrons to determine if the donee organization has complied with the ''clear designation'' requirement.[186]

(b) Disclosure of Nondeductible Contributions

Tax-exempt organizations that are ineligible to receive deductible contributions generally are required to disclose in their fundraising materials, in a conspicuous and easily recognizable format, that gifts to them are not deductible as charitable contributions for federal income tax purposes.[187] This rule is directed at organizations such as social welfare organizations,[188] labor organizations,[189] associations,[190] social clubs,[191] fraternal organizations,[192] and political organizations.[193] There is a penalty for failure to comply with this rule.

[185]See App. C § XIV A.
[186]IRM 4.76.51.3.
[187]See App. C § XIV D.
[188]See § 7.1(i).
[189]See § 7.1(k).
[190]See § 7.1(m).
[191]See § 7.1(n).
[192]See § 7.1(o).
[193]See § 7.1(bb).

An IRS examiner in this context will:

- Determine if the exempt organization is subject to this disclosure rule.
- Identify all fundraising activities conducted by the organization.
- Determine if a particular activity is excluded from the disclosure requirement.
- Review printed materials involving solicitation activities and determine if the disclosure requirement was satisfied.
- Consider the applicability of penalties should areas of noncompliance be identified.[194]

(c) Disclosure of Quid Pro Quo Contributions

A charitable organization that receives a quid pro quo contribution in excess of $75 is generally required to provide certain disclosures to the donor concerning the fair market value of goods or services the donor received from the donee.[195] A penalty may be imposed for violation of this rule. An IRS examiner in this circumstance will:

- Review the solicitation materials and records to determine if the organization provided any benefits in return for contributions in excess of $75.
- Determine if the organization provided the disclosure notice with either the solicitation or the receipt of the quid pro quo contribution.
- Ascertain whether the goods or services provided have an insubstantial value.[196]
- Consider the impact on the deductibility of the contribution to the donor.[197]
- Evaluate the appropriateness of penalties in instances of noncompliance.[198]

(d) Unrelated Business Rules

The IRS examiner will evaluate the fundraising activities of a tax-exempt organization to determine if any of the activities constitute an unrelated trade or business.[199] Particular focus will be on the conduct of bingo games and other

[194]IRM 4.76.51.4.
[195]See App. C § XIV C.
[196]See *Charitable Giving* § 10.1.
[197]Taxpayers deducting large nondeductible payments may be referred for personal examination.
[198]IRM 4.76.51.5.
[199]See App. C § IX.

gambling activities that are open to the public.[200] Another field of inquiry will be contributed real property subject to debt-financing.[201]

Fundraising activities may escape unrelated business income taxation if they are businesses that are not regularly carried on,[202] businesses where substantially all of the work is conducted by volunteers,[203] businesses consisting of the sale of donated items,[204] solicitation activities involving the use of low-cost articles,[205] and/or qualified sponsorship payments.[206]

(e) Non-Cash Charitable Contributions

During the initial interview,[207] the IRS examiner of a charitable organization may be expected to ask the following questions concerning the treatment of non-cash charitable contributions:

- Does the organization have a formal policy regarding non-cash charitable contributions?
- How does the organization value non-cash donated property?
- Does the organization utilize the services of an independent appraiser?
- Does the organization assign a value of the property on the gift acknowledgment provided to the donor?[208]
- What procedures are in place if the organization determines that the value of the property is less than the value claimed by the donor?
- Does the organization maintain copies of appraisal summaries (Form 8283) for non-cash contributions?

As to this last question, the IRS examiner will determine whether the donee organization properly completed and signed the donee acknowledgment portion of the form.

The federal tax law requires charitable donees to provide donors with a contemporary written acknowledgment (substantiation) of the contribution, where the amount of the gift is at least $250.[209] The above-referenced policy as

[200]See § 7.7.
[201]See *Tax-Exempt Organizations* § 24.12; *Unrelated Business*, Chapter 5.
[202]See App. C § IX B.
[203]See *id*. § IX D.
[204]*Id*.
[205]*Id*.
[206]*Id*. IRM 4.76.51.6.
[207]See § 5.18(g).
[208]Charitable organizations should not engage in this practice; they do, however, have to value the property for purposes of annual reporting of revenue and (if applicable) calculating public support.
[209]App. C § XIV B. The examination guidelines omit reference to this $250 threshold element. Indeed, the guidelines suggest that the threshold is $5,000. Thus, there may be some confusion on this point during an IRS examination.

to non-cash charitable contributions generally will include a practice as to gift substantiation. (There is no penalty for failure to provide this acknowledgment; rather, the donor is penalized by disallowance of any charitable deduction. A charitable organization, however, that knowingly prepares an inaccurate substantiation statement may be subject to a penalty for aiding and abetting an understatement of tax liability.[210])

Non-cash contributions in excess of $5,000 to charitable organizations are deductible where the donors obtained a qualified written appraisal of the property.[211] The IRS examiner may refer a case, involving a large charitable deduction claimed in the absence of a qualified appraisal, for referral for examination of the donor. (Again, there is no penalty in this regard on the charitable donee; the sanction for failure to procure the requisite appraisal is loss of the charitable deduction.)

The aspect of non-cash charitable contributions that may most interest the examiner is the requirement that a charitable organization that disposes of charitable deduction property[212] within two years of its receipt must file an information return (Form 8282) containing certain information. There is a penalty for failure to file this form.[213] Consequently, of course, the examiner will determine whether this form was timely filed and, where appropriate, whether a penalty should be imposed. The examiner will also compare the amount received by the charitable organization on disposition of the property to the amount claimed by the donor for purposes of a charitable deduction; the guidelines state that a ''large variance'' could be an indication that the appraised value was excessive and the claimed deduction inaccurate, inviting the examiner to refer the matter for examination of the donor.[214]

(f) Internet Fundraising

The examination guidelines observe (indisputably) that the Internet is presenting ''many new opportunities for tax-exempt organizations to raise revenues to finance their operations.'' The guidelines reflect the IRS's general view that web site and e-mail solicitations should comply with the same rules

[210]See *Charitable Giving* § 10.14.
[211]See App. C § XIV E.
[212]See *id*. § VIII C.
[213]*Id*. The examination guidelines suggest that, if this information return is not timely filed, the donor is not entitled to a charitable contribution deduction but that is not the law.
[214]IRM 4.76.51.7. IRS examiners have been known to take the position that, if the amount on the Form 8282 is less than the amount claimed as a charitable deduction, the donor automatically must file an amended return and reduce the deduction accordingly. This is not the law. There may be a valid reason why the charity disposed of the property for less than the claimed value (e.g., desperate need for funds). Thus, the amount received by the charitable donee on disposition of the gift property does not always mean that the donor's asserted value was erroneous.

that are applicable to other forms of solicitations.[215] Consequently, an IRS examiner may be expected to do the following:

- Treat e-mail solicitation in the same manner as direct-mail solicitation.
- Visit the exempt organization's web site to identify any fundraising activities it conducts by that means.
- Explore the nature of the organization's acknowledgments of sponsors and donors on its web site to determine whether the resulting revenue is nontaxable sponsorship revenue[216] or taxable advertising revenue.[217]
- Explore sales of merchandise by means of the web site to determine if any of the sales constitute unrelated business.
- Determine if the organization is in compliance with the rules imposed on noncharitable fundraising organizations.[218]

(g) Annual Reporting

The IRS examiner will review the tax-exempt organization's annual information return(s) to ascertain whether it is in compliance with the portions of the reporting requirements that pertain to fundraising. In that connection, the examiner will:

- Review the statement of functional expenses[219] to verify that the organization has (if required to do so) properly allocated expenses among the categories of program, management, and fundraising.
- Determine whether the organization has engaged in any special fundraising activities and, if so, properly reported the income and expenses.[220]
- Review the organization's fundraising programs to determine if it provided or provides any benefits to contributors that would affect the deductibility of the contribution.
- Identify the officials responsible for soliciting and accounting for gifts, and obtain a description of their duties and responsibilities.
- Interview the employees who plan and administer the organization's fundraising activities.
- Review minutes of the governing board and fundraising committees (such as development or finance) to identify any conditional contributions that may have ''questionable terms.''

[215]See *Fundraising* § 4.13.
[216]See App. C § IX E.
[217]See *id*.
[218]IRM 4.76.51.8. See 7.6(b).
[219]See App. C § VII A.
[220]See *id*.

- Review internal reports related to gifts (such as a list of contributors or list of restricted gifts) to determine any contributions that ''may not be at arm's length.''
- Review correspondence files relating to solicitations of contributions and any agreements concerning gifts received to identify restricted, earmarked, or conditional contributions, and analyze the terms and conditions of the contributions to identify any private inurement, private benefit, or indications of nonexempt activities.
- Review contracts with professional fundraisers to identify fees charged as a percentage of funds raised or excessive fees.

If the examiner determines that another tax-exempt, charitable organization conducts an organization's fundraising activities, the examiner is expected to inspect the fundraising organization's annual information return(s) and ascertain if an examination of that organization is warranted.[221]

§ 7.7 GAMING

The IRS's tax-exempt organizations examination guidelines contain detailed procedures as to various areas that may warrant review in an examination of an exempt organization that is conducting gaming activities.[222] The principal focus of these guidelines is on bingo and pull-tab games.[223] Examiners are exhorted to use their professional judgment in determining the scope and depth of these types of examinations.[224]

(a) Preexamination Analysis

The IRS examiner is expected to review the appropriate state's gaming laws, with emphasis on the types of organizations that are allowed to conduct gaming activities and the conditions pursuant to which the games may be conducted (such as a requirement that volunteers be utilized or a limit on the number of nights in a week a tax-exempt organization can conduct a gaming activity).[225] The examiner will determine the state agency in charge of gaming activities enforcement[226] and review the state's reporting requirements (such as reporting in connection with a gaming license or general financial reporting).

[221]IRM 4.76.51.9.

[222]See App. C § XII A.

[223]These terms are defined at 4.76.50.1.1 § 1A and B. See § 7.7(c), (d).

[224]IRM 4.76.50 § 1. The IRS has an Industry Specialist for Gaming function, which can be of assistance to an examiner, particularly with respect to games other than bingo and pull-tabs.

[225]The guidelines note that state gaming laws are ''revised frequently,'' so that the examiner should be certain that the laws being followed are those in effect for the year(s) under examination.

[226]The examiner is encouraged to establish a ''personal contact'' in the agency.

The examiner will review audit reports and/or investigative memoranda prepared by state regulators, such as the office of the attorney general.[227]

(b) Initial Contact Interview

The examiner is expected to conduct a ''detailed interview'' with the exempt organization's officers to determine its organizational structure and history, and whether the board monitors the game(s) to ensure that all funds are collected from the operators. The questions to be posed in this regard are the following:

- What types of gaming activities are being conducted by the organization?
- Who conducts the activity?
- Who owns the hall where the gaming activities are conducted?
- How are the games advertised?
- Who are the suppliers of the gaming equipment and/or supplies?
- What are the relationships between the exempt organization and the parties involved in the conduct of the gaming activities, such as the:
  - Suppliers of the game pieces
  - Suppliers of the equipment
  - Operators of the games
  - Owner of the hall
  - Workers (employees, independent contractors, volunteers)
- How long has the gaming activity been conducted?
- Is the gaming activity a departure from previous activities?
- What is the size and extent of the gaming activities on an income, expense, and time basis?
- Has the manner in which the games have been conducted changed over time?

The examiner will, in this connection, review board minutes and contracts, and interview current and (if possible) past employees.[228] Among the issues on the mind of the examiner will be private inurement and private benefit.[229]

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[227] IRM 4.76.50 § 2.

[228] As to past employees, the guidelines recognize that one or more summonses (see § 1.8) may have to be issued for that information.

[229] IRM 4.76.50 § 3. See App. C §§ II D, E.

(c) Analysis of Bingo Activity

The examination guidelines, after enumerating the various sources of cash that flows into a typical bingo operation, observe that ''[s]ubstantial amounts of cash pass through many hands at the typical bingo operation, leaving the operation subject to numerous abuses.'' Thus, an IRS examiner of one of these operations will determine whether the bingo operation has a system of internal controls (including checks on the individuals involved) to adequately safeguard the revenue generated from the games. An example is provided of various positions and responsibilities in place in conjunction with a properly functioning bingo operation.

The examiner will monitor the gaming activity while it is in operation. He or she will compare cash receipts received at the door from bingo players (such as by a count of players and estimates of average per-player purchases) to door receipts reported previously by the bingo operation. These on-site observations cannot confirm or disprove the accuracy of reported receipts; they are, however, likely to assist the examiner in determining the appropriate scope of the audit.

The examiner may interview workers to determine if they are compensated for their services. Where the tax-exempt organization asserts that its workers are volunteers, the examiner will probably request signed affidavits from these individuals[230] stating that they are uncompensated. The examiner will determine whether other organizations conduct bingo operations at the same location; this may lead to examination of one or more other organizations.[231]

The guidelines require the examiner to conduct a bingo gross receipts analysis, which will include reconciliation of the bingo operation's gross receipts reported on the exempt organization's annual information return to the gross receipts reported on the summary of the daily bingo sheets. ''Close scrutiny'' is required if currency deposits are not made soon after each bingo occasion. The examiner will determine the potential for unreported revenue by analyzing gross receipts and/or by ascertaining a reasonable basis for estimating the average number of packages purchased per player, determining the average spent per player (as reported on the daily sheets), and comparing the average spent per player as reported to the average spent per player using the average number of packages purchased times the cost of the packages.[232] Also, the examiner will undertake an expense analysis, such as where a charitable organization raises funds from gaming activities and makes payments to other charitable organizations.[233]

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[230]The names of the appropriate individuals are usually listed on the exempt organization's bingo license application.
[231]IRM 4.76.50.4.
[232]IRM 4.76.50.6.2.
[233]IRM 4.76.50.7.

(d) Analysis of Pull-Tab Activity

The IRS examiner of pull-tab activity will likely review the tax-exempt organization's inventory of pull-tab supplies, comparing the boxes of pull-tabs to supplier invoices (the absence of which may indicate diversion of the exempt organization's funds). If the exempt organization's records do not reflect all pull-tab purchases, the examiner may secure information from pull-tab manufacturers and/or suppliers to aid in reconstructing purchases. (State laws generally require manufacturers and suppliers to have internal control procedures that enable them to track pull-tab tickets by serial number.)

The examiner will monitor the pull-tab sales; indeed, the guidelines ''strongly recommend'' that the examiner make an ''unannounced visit'' to view the gaming activities. More attention is likely to be accorded situations where the exempt organization uses floor workers to sell pull-tabs continuously before, during, and after the games than sales solely from a booth. Pull-tabs may be sold in arrangements with bars and restaurants; the nature of the arrangement between the exempt organization and the bar or restaurant will be determined.[234]

The guidelines require the examiner to conduct a pull-tab gross receipts analysis, which includes an examination as to the potential for unreported profits. (The guidelines note that, for every dollar spent on pull-tab supplies, $8 to $10 in pull-tab profits is usually generated.) A step-by-step analysis is provided for use by an examiner who suspects that an exempt organization is underreporting pull-tab profits (such as consistent reporting of $6 or less in profits).[235] Also, the examiner will undertake an expense analysis, such as where a charitable organization raises funds from gaming activities and makes payments to other charitable organizations.[236]

(e) Unrelated Business Activities

Generally, the regular operation by a tax-exempt organization of gambling activities is the conduct of an unrelated business, particularly where the activities involve the public. In some instances, gaming activities can be substantially related activities, such as when conducted by an exempt organization for social or recreational purposes for its members. A statutory exception is available for qualified bingo games.[237] Bingo games may be exempt functions of social clubs and political organizations.[238]

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[234]IRM 4.76.50.5.

[235]IRM 4.76.50.6.3.

[236]IRM 4.76.50.7.

[237]One of the elements for this qualification is that the bingo game not be in violation of state or local law. The IRS examiner may obtain a legal opinion from the state or local law enforcement agency on the point.

[238]IRM 4.76.50.8.

(f) Qualification for Exempt Status

Gaming activities may adversely affect a tax-exempt organization's exempt status. For example, if a charitable organization engages in these activities for nonexempt purposes and the activities are substantial, tax exemption may be imperiled. If, however, the organization has a program of making grants to other charities from its gaming activities' revenue, the commercial or business aspects of the gaming may be considered incidental to the charitable purposes. An IRS examiner will evaluate the organization's ongoing entitlement to exemption in this regard.

A gaming activity, conducted by a charitable or social welfare organization, which is illegal may jeopardize the organization's tax exemption on the ground that it is contrary to public policy (or otherwise ''tends to induce the commission of crime'').[239] Gaming activities may also endanger tax exemption if they violate the doctrines of private inurement or private benefit, or transgress the intermediate sanctions rules. A private benefit analysis is likely to require application of the commensurate test.[240]

(g) Public Charity Status

The receipt of gaming income may have an adverse effect on a charitable organization's public charity status if it is a publicly supported charity.[241] This determination turns, in large part, on whether the income is unrelated business income.[242] In ascertaining whether a charitable organization qualifies as a donative-type publicly supported charity, gross receipts from activities that do not constitute unrelated business (including nontaxable bingo receipts) are excluded from the computation of public support. In determining whether a charitable organization is a service provider publicly supported charity, gross receipts, if not unrelated business income, are likely to qualify as public support. A charitable organization that receives all or substantially all of its revenue in the form of gaming income from unrelated business will likely not qualify for exemption; in that instance, public charity/private foundation status would presumably be moot. Even if the organization were classified as a private foundation, the gaming activities would presumably constitute an excess business holding.[243] An IRS examiner will explore these considerations.[244]

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[239]See *Tax-Exempt Organizations* § 6.2(a).
[240]IRM 4.76.50.9. See App. C § II G.
[241]See App. C § V C.
[242]See *id*. § IX.
[243]See *id*. § V F.
[244]IRM 4.76.50.9.2.

(h) Related Entities

The IRS examiner will attempt to identify related entities early in the examination process. That is, the gaming operation may have related management, real estate, supply, equipment, or concession companies. The examiner will review agreements, including subleases, looking for private inurement or private benefit in forms such as excessive compensation, lengthy contract terms, penalties on the exempt organization in case of termination of an agreement, and lack of open bidding in selection of the gaming operator.[245]

If related entities are found, the examiner will determine the nature of the relationship between the parties: agency, joint venture, sales, license, or a ''more complex arrangement.'' The latter arrangement generally is where a relationship embodies more than one of these elements, such as a tax-exempt organization that licenses its right to conduct gaming but hires a manager for concessions. A determination as to what entity is conducting the gaming activity can affect the conclusion as to whether the activity is legal under state law, is an unrelated business, or leads to revocation of exemption (such as because of private benefit).[246]

(i) Other Matters

The examiner will, of course, review the books and records of the tax-exempt organization conducting the gaming operations, examine the exempt organization's returns (and correlate them with the returns filed by gaming operators (Form 1040, 1120)), and issuance of a tax form to prizewinners (Form W-2G), to determine if the organization is liable for federal excise taxes on wagering, and in compliance with the rules as to employment taxes and tip income.[247]

[245]Federal tax law, however, does not require tax-exempt organizations to engage in a bidding process in selecting entities with which to enter into contracts.
[246]IRM 4.76.50.10, 4.76.50.11.
[247]IRM 4.76.50.12, 4.76.50.13.

APPENDIX A

Sources of the Law

The law as described in this book is derived from many sources. For those not familiar with these matters and/or wishing to understand precisely what the ''law'' underlying audits of tax-exempt organizations is, the following explanation should be of assistance.

FEDERAL LAW

At the federal (national) level in the United States, there are three branches of government as provided for in the U.S. Constitution. Article I of the Constitution established the U.S. Congress as a bicameral legislature, consisting of the House of Representatives and the Senate. Article II of the Constitution established the Presidency. Article III of the Constitution established the federal court system.

Congress

Congress created the legal structure underlying the federal law for nonprofit organizations. Most of this law is manifested in the tax law and thus appears in the Internal Revenue Code. Other laws written by Congress that can affect nonprofit organizations include the postal, employee benefits, antitrust, labor, political campaign financing, corporate responsibility, insurance, and securities laws.

Statutory Law in General. Tax laws for the United States must originate in the House of Representatives (U.S. Constitution, Article I § 7). Traditionally, most of the nation's tax laws are formally initially written by the members and staff of the House Committee on Ways and Means, although in recent years the Senate Committee on Finance has been in the forefront in writing tax legislation. A considerable portion of this work is performed by the staff of the Joint Committee on Taxation, which consists of members of the House and Senate. Frequently, these laws are generated by work done at the House subcommittee level, usually the Subcommittee on Oversight or the Subcommittee on Select Revenue Measures. Most tax legislation is the subject of hearings before the House Ways and Means Committee and the

Senate Finance Committee. Nearly all of this legislation is finalized by a House-Senate conference committee, consisting of senior members of the House Ways and Means Committee and the Senate Finance Committee.

A Congress sits for two years, which is termed a ''session.'' Each Congress is sequentially numbered. For example, the 110th Congress is meeting during the calendar years 2007–2008. A legislative development that took place in 2008 is referenced as occurring during the 110th Congress, 2nd Session (''110th Cong., 2nd Session (2008)'').

A bill introduced in the House of Representatives or Senate during a particular Congress is given a sequential number in each house. For example, the 3,000th bill introduced in the House of Representatives in 2008 is cited as ''H.R. 3000, 110th Cong., 2nd Sess. (2008)''; the 2000th bill introduced in the Senate in 2008 is cited as ''S. 2000, 110th Cong., 2nd Sess. (2008).''

A tax bill, having passed the House and Senate, and usually blended by a conference committee, is sent to the President for signature. Once signed, the measure becomes law, causing enactment of one or more new and/or amended Code sections.

Legislative History. A considerable amount of the federal tax law for nonprofit organizations is found in the legislative history of these statutory laws. Most of this history is in congressional committee reports. Reports from committees in the House of Representatives are cited as ''H. Rep.''; reports from committees in the Senate are cited as ''S. Rep.''; conference committee reports are cited as ''H. Rep.'' The IRS wrote that committee reports are ''useful tools in determining Congressional intent behind certain tax laws, and helping examiners apply the law properly.''[1]

Transcripts of the debate on legislation, formal statements, and other items are printed in the Congressional Record *(Cong. Rec.)*. The Congressional Record is published every day one of the houses of Congress is in session and is cited as ''____ *Cong. Rec.* ____ (daily ed., [date of issue]).'' The first number is the annual volume number; the second number is the page in the daily edition on which the item begins. Periodically, the daily editions of the Congressional Record are republished as a hardbound book and are cited as ''____ *Cong. Rec.* ____([year]).'' As before, the first number is the annual volume number and the second is the beginning page number. The bound version of the Congressional Record then becomes the publication that contains the permanent citation for the item.

Internal Revenue Code. The Internal Revenue Code, the current version of which is the Internal Revenue Code of 1986, is the primary source of the federal

[1]IRM 4.75.13.6.2 § 3.

tax law.[2] This Code is officially codified in Title 26 of the United States Code and referenced throughout the book as the ''IRC'' (see Chapter 1, note 7). (The United States Code consists of 50 titles, The IRC imposes income, estate, gift, generation-skipping, excise, and employment taxes, and includes penalties and other provisions concerning the administration of federal taxation.

The IRC includes subtitles (of which there are 11), chapters, subchapters, parts, and sections. Code sections are divided into subsections, paragraphs, subparagraphs, and clauses.[3] The most relevant of the subtitles are the following:

Subtitle Contents	IRC Sections
A Income Taxes	1–1563
B Estate and Gift Taxes	2001–2704
C Employment Taxes	3101–3510
D Excise Taxes	4041–5000
F Procedure and Administration	6001–7873
G Joint Committee on Taxation	8001–8023

Sections of the IRC are usually arranged in numerical order. When the IRS cites an IRC section, it does not usually reference the title, subtitle, chapter, subchapter, or part. It references a Code section as ''IRC §'' (as does this book). As noted, IRC sections are divided into subsections, paragraphs, subparagraphs, and clauses. For example, IRC § 170(b)(1)(A)(vi) is structured as follows:

1. IRC § 170—Code section, Arabic number
2. Subsection (b)—lowercase letter in parentheses
3. Paragraph (1)—Arabic number in parentheses
4. Subparagraph (A)—capital letter in parentheses
5. Clause (vi)—lowercase Roman numeral in parentheses

Inasmuch as IRC sections are usually arranged in numerical order, this practice sometimes leads to the need to show a Code section number followed by a capital letter that is not in parentheses. An example of this is IRC § 409A. This came about because Congress created an IRC § that needed to immediately follow IRC § 409 and IRC § 410 already existed. There are no IRC sections of this nature within the direct ambit of the law of tax-exempt organizations.[4]

[2]The IRS, in a peculiar understatement, advises its examiners that ''[i]t is often necessary to cite Internal Revenue Code sections in reports and to taxpayers in support of a position on an issue'' (IRM 4.75.13.6.1.2 § 1).

[3]According to the IRS, this structure results in ''ease of use'' of the IRC (IRM 4.75.13.6.1 § 2).

[4]IRC § 409A is a part of the federal tax law of employee benefits and can be applicable with respect to tax-exempt organizations.

The IRC is generally binding on the courts. As the IRS has written, the courts ''give great importance to the literal language of the Code, but the language does not solve every tax controversy.''[5] Thus, courts also consider the legislative history underlying a Code section, its relationship to other Code sections, tax regulations, and various IRS pronouncements.

Executive Branch

A function of the Executive Branch in the United States is to administer and enforce the laws enacted by Congress. This ''executive'' function is performed by departments and agencies, and ''independent'' regulatory commissions (such as the Federal Election Commission or the Securities and Exchange Commission). The federal tax laws are administered and enforced overall by the Department of the Treasury.

Tax Regulations. The Code of Federal Regulations (CFR) is a codification of the general and permanent rules published in the Federal Register by the executive departments and agencies of the federal government. The CFR is divided into 50 titles representing broad areas subject to federal regulation. Each title is divided into chapters that usually bear the name of the issuing agency. Each chapter is subdivided into parts covering specific regulatory areas. Title 26 of the CFR consists of the federal tax regulations.

One of the ways in which the Department of the Treasury executes its functions is by the promulgation of regulations (Reg.), which are designed to interpret and amplify the related statute (see, e.g., Chapter 1, note 9). Treasury regulations are the official interpretations of the Department of the IRC; they follow the numbering sequence of IRC sections.

Tax regulations are written by the Legislative and Regulations Division or Tax Exempt and Government Entities Office of Associate Chief Counsel (Technical), IRS; the Department of the Treasury must approve regulations for them to take effect. There are three classes of tax regulations:

1. *Proposed regulations.* Proposed regulations provide guidance concerning the Treasury Department's interpretation of an IRC section but do not have authoritative weight (because they are in proposed form); thus they are not binding on taxpayers and IRS examiners. The public is accorded an opportunity to comment on a proposed regulation; a public hearing on the proposal may be held if sufficient written requests are received. Proposed regulations become effective when adopted by a Treasury Decision and become final regulations.
2. *Temporary regulations.* Temporary regulations are often issued soon after a major statutory law change to provide guidance to the public and

[5]IRM 4.75.13.6.1.

IRS employees with respect to procedural and computational matters. Temporary regulations are authoritative and have the same weight as final regulations. Public hearings are not held on temporary regulations.

3. *Final regulations.* Final regulations are issued after public comments on the regulations in proposed form are evaluated. They supersede any temporary regulations on the point. A final regulation is effective as of the day it is published in the Federal Register as a Treasury Decision, unless otherwise stated.

Tax regulations (like other rules made by other government departments, agencies, and commissions) generally have the force of law, unless they are overly broad in relation to the accompanying statute or are unconstitutional, in which case they can be rendered void by a court. These regulations are not binding on courts; they are binding on the IRS. If temporary and proposed regulations have been issued in connection with the same Code provision, and the text of both are similar, examiners' positions should be based on the temporary regulations. If neither temporary nor final regulations have been issued, IRS examiners may use a proposed regulation to support a position; they should, however, indicate that the proposed regulation lacks authoritative weight but is the best (at least from the standpoint of the IRS) interpretation of the statutory law involved that is available. Regulations may apply only to a particular time period. Regulations do not always reflect changes in the law.

There are two types of final tax regulations: legislative and interpretative. The standard of review by a court applicable to a final regulation differs as between these types of regulations. A *legislative regulation* is a final regulation issued under a specific grant of congressional authority to prescribe a method of executing a statutory provision. In this instance, a Code provision will state: ''The Secretary shall provide such regulations . . . .''[6] In contrast, an *interpretative regulation* is promulgated pursuant to the Treasury's general authority to prescribe regulations.[7] Courts accord a higher degree of deference to a legislative regulation than to an interpretative one.

The deference accorded a legislative regulation is so high that the regulation has controlling weight unless it is arbitrary, capricious, or manifestly contrary to the underlying statute.[8] This standard of deference is sometimes referred to as the *Chevron deference*.[9] Thus, when reviewing a legislative regulation, a

[6]For example, *Snap Drape, Inc. v. Comm'r*, 98 F.3d 194 (5th Cir. 1996).
[7]IRC § 7805.
[8]For example, *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984); *Fransen v. United States*, 191 F.3d 599 (5th Cir. 1999).
[9]For example, *Belt v. EmCare, Inc.*, 444 F.3d 403, 416, note 35 (5th Cir. 2006); *Klamath Strategic Investment Fund, LLC v. United States*, 2007-1 U.S.T.C. ¶ 50,410 (E.D. Tex. 2007). In *Klamath*, the regulation at issue was held to be an interpretative regulation.

court ''may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency.''[10]

A tax regulation may be made retroactive; this type of regulation can be reviewed by a court for abuse of discretion. The IRS ''does not have carte blanche'' authority to issue retroactive regulations.[11] The efficacy of a retroactive regulation is tested against these factors: whether or to what extent the taxpayer justifiably relied on settled law or policy and whether or to what extent the putatively retroactive regulation alters that law or policy; the extent to which the prior law or policy has been implicitly approved by Congress, as by legislative reenactment of the pertinent Code provision(s); whether retroactivity would advance or frustrate the interest in equality of treatment among similarly situated taxpayers; and whether according retroactive effect would produce an inordinately harsh result.[12]

Revenue Rulings and Procedures. Within the Department of the Treasury is the Internal Revenue Service (IRS). The IRS is, among its many roles, a tax-collecting agency. The IRS, while headquartered in Washington, D.C. (its ''National Office''), has regional and field offices throughout the country.

The IRS's jurisdiction over tax-exempt organizations is principally lodged within the office of the Director, Exempt Organizations, who is responsible for planning, managing, directing, and executing nationwide activities for exempt organizations. The Director reports to the Tax Exempt Entities/Government Entities Division Commissioner. The Director supervises the activities of the offices of Customer Education and Outreach, Rulings and Agreements, and Examinations.

The IRS (from its National Office) prepares and disseminates guidance interpreting tax statutes and tax regulations. This guidance has the force of law, unless it is overly broad in relation to the statute and/or Treasury regulation involved, or is unconstitutional. The Internal Revenue Bulletin (I.R.B.), published weekly, is the publication used by the IRS to announce official IRS rulings and procedures, and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. Every six months, the I.R.B.s are republished as hardbound books, with the resulting publication termed the Cumulative Bulletin (C.B.).

The C.B. is a consolidation of items of a permanent nature first published in the I.R.B.; it consists of four parts:

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[10]*Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843–844 (1984). For example, *Littriello v. United States*, 484 F.3d 372 (6th Cir. 2007) (holding that the check-the-box entity classification regulations [*Tax-Exempt Organizations* § 4.1(b)] are valid, using the *Chevron deference* standard).

[11]*Snap Drape, Inc. v. Comm'r*, 98 F.3d 194, 202 (5th Cir. 1996).

[12]For example, *Anderson, Clayton & Co. v. United States*, 562 F.2d 972 (5th Cir. 1977); *Klamath Strategic Investment Fund, LLC v. United States*, 2007-1 U.S.T.C. ¶ 50,410 (E.D. Tex. 2007).

Part I: This part is divided into two subparts based on provisions of the IRC. Arrangement is sequential according to IRC and regulation sections. The Code section is shown at the top of each page.

Part II: This part is divided into two subparts, one concerning tax conventions and the other pertaining to legislation and related congressional committee reports.

Part III: This part concerns various administrative, procedural, and miscellaneous matters.

Part IV: The preambles and text of proposed regulations that were published in the Federal Register during the six-month period involved are printed in this part. Also included in this portion of the C.B. is a list of individuals disbarred or suspended from practice before the IRS.

The IRS publishes in the I.R.B. all substantive rulings necessary to promote uniform application of the federal tax laws, including rulings that supersede, revoke, modify, or amend rulings previously published in the I.R.B. All published rulings apply retroactively, unless otherwise indicated.[13] Procedures pertaining solely to matters of internal IRS management are not published in the I.R.B. Nonetheless, statements of internal practices and procedures that affect the rights and duties of taxpayers are so published.

IRS public determinations on a point of law usually are in the form of ''revenue rulings'' (Rev. Rul.); those that are rules of procedure are termed ''revenue procedures'' (Rev. Proc.). A Rev. Rul. represents the conclusion(s) of the IRS on application of the law to the facts stated in the ruling. Some Rev. Ruls. are based on positions taken by the IRS in private letter rulings or technical advice memoranda. A Rev. Proc. is issued to assist taxpayers in complying with procedural issues. The purpose of these rulings and procedures is to promote uniform application of the tax laws. IRS employees must follow them; taxpayers may rely on them or appeal their position to the courts.

Rev. Ruls. and Rev. Procs. that have an effect on previous rulings use the following terms to describe the effect:

- *Amplified* describes a situation where a change is not being made in a prior published position of the IRS but the prior position is being extended (amplified) to apply to a variation of the original fact situation.
- *Clarified* is used in instances where the language in a prior ruling is being made clearer because the original language has or may cause confusion.
- *Distinguished* describes a situation where a ruling makes reference to a previously published ruling and points out one or more essential difference between them.

[13]Cf. text accompanied by *supra* note 11.

- *Modified* is used where the substance of a previously published position is being changed.
- *Obsoleted* describes a previously published ruling that is not considered determinative with respect to future transactions. The term is most commonly used in a ruling that lists previously published rulings that are obsolete because of changes in the statutory law or regulations. A ruling may also be rendered obsolete because the substance of it has been included in subsequently adopted regulations.
- *Revoked* describes situations where the position of the IRS in a previously published ruling is not correct and the correct position is being stated in a new ruing.
- *Superseded* describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling or rulings. The term is used by the IRS when it is desirable to republish in a single ruling a series of situations and the like that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified and superseded* describes a situation where the substance of a previously published ruling is being changed in part and is being continued without change in part, and the IRS desires to restate the valid portion of the previously published ruling in a new ruling that is self-contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.
- *Supplemented* is used in situations in which a list is published in a ruling and that list is expanded by adding items in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.
- *Suspended* is used in rare situations to show that a previously published ruling will not be applied pending some future action, such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of an IRS study.[14]

The IRS considers itself bound by its revenue rulings and revenue procedures. These determinations are the ''law,'' particularly in the sense that the IRS regards them as precedential, although they are not binding on the courts. Rulings do not have the force and effect of regulations. In applying rulings, the effects of subsequent legislation, regulations, court decisions, and other rulings and procedures need to be considered.

[14]The citation formats for IRS revenue rulings and revenue procedures are the subject of § 2.10.

Other IRS Pronouncements. The IRS also issues forms of ''public'' law in the name of ''notices'' and ''announcements,'' as well as ''Delegation Orders.'' A notice or Delegation Order is initially published in the I.R.B. and then republished in the C.B. An announcement, however, although published in the I.R.B., is not republished in the C.B.

Announcements are public pronouncements on matters of general interest, such as the effective dates of temporary regulations, and clarification of rulings and form instructions. They are issued when guidance of a substantive or procedural nature is needed quickly. Announcements can be relied on to the same extent as revenue rulings and revenue procedures, when they include specific language to that effect. Announcements are identified by a two-digit number, representing the year involved, and a sequence number (e.g., Ann. 2008-25). Notices are public announcements that are identified in the same manner as announcements (e.g., Notice 2008-50).

Commissioner Delegation Orders formally delegate, by the Commissioner of Internal Revenue, authority to perform certain tasks or make certain decisions to specified employees of the IRS. Agreements entered into by IRS personnel pursuant to these orders are binding on taxpayers and the agency. Delegation Orders are identified by a number, sometimes followed by a revision date (e.g., Del. Order 250).

The IRS issues plain-language publications to explain aspects of the federal tax law. They typically highlight changes in the law, provide examples of IRS positions, and include worksheets. These publications, which do not necessarily cover all positions for a given issue, are not binding on the IRS. While a good source of general information, IRS examiners are not supposed to cite to these publications in support of a position.

Private Determinations. By contrast to these forms of ''public'' law, the IRS (again from its National Office) also issues ''private'' or nonprecedential determinations. These documents principally are private letter rulings and technical advice memoranda. As a matter of law, these determinations may not be cited as legal authority.[15] Nonetheless, these pronouncements can be valuable in understanding IRS thinking on a point of law and, in practice (the statutory prohibition notwithstanding), these documents are cited as IRS positions on issues, such as in court opinions,[16] articles, and books.

The IRS issues private letter rulings in response to written questions (termed ''ruling requests'') submitted to the IRS by individuals and organizations. An IRS district office may refer a case to the IRS National Office for advice (termed ''technical advice''); the resulting advice is provided to the IRS district office in the form of a technical advice memorandum. In the course of preparing a revenue ruling, private letter ruling, or technical advice

[15]IRC § 6110(k)(3).

[16]See the discussion of *Glass v. Comm'r*, 471 F.3d 698 (6th Cir. 2006), in § 2.10, note 130.

memorandum, the IRS National Office may seek legal advice from its Office of Chief Counsel; the resulting advice was provided, until recently, in the form of general counsel memorandum. These documents are eventually made public, albeit in redacted form. The chief counsel advice memorandum has replaced the general counsel memorandum.

Private letter rulings and technical advice memoranda[17] are identified by seven- or nine-digit numbers, as in ''Priv. Ltr. Rul. 200726007'' (see, e.g., Chapter 1, note 49). The first two (or four) numbers are for the year involved (here, 2007), the next two numbers reflect the week of the calendar year involved (here, the 26th week of 2007), and the remaining three numbers identify the document as issued sequentially during the particular week (here, this private letter ruling was the seventh one issued during the week involved).

The agency has, pursuant to court order,[18] also commenced issuance of rulings denying or revoking tax-exempt status. These exemption denial and revocation letters initially were identified by eight numbers, followed by an *E*. This practice was discontinued by the IRS, however; these letters are now being issued as private letter rulings.

Judiciary

The federal court system has three levels: trial courts (including those that initially hear cases where a formal trial is not involved), courts of appeal (''appellate'' courts), and the U.S. Supreme Court. The trial courts include the various federal district courts (at least one in each state, the District of Columbia, and the U.S. territories), the U.S. Tax Court,[19] and the U.S. Court of Federal Claims.[20] There are 13 federal appellate courts (the U.S. Court of Appeals for the First through the Eleventh Circuits, the U.S. Court of Appeals for the District of Columbia, and the U.S. Court of Appeals for the Federal Circuit).

Cases involving tax-exempt organization issues at the federal level can originate in any federal district court, the U.S. Tax Court, and the U.S. Court of Federal Claims. Under a special declaratory judgment procedure available only to charitable organizations and farmers' cooperatives,[21] cases can originate only with the U.S. District Court for the District of Columbia, the U.S. Tax Court, and the U.S. Court of Federal Claims. Cases involving tax-exempt organizations are considered by the U.S. Courts of Appeals and the U.S. Supreme Court.

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[17]See § 1.9.

[18]See the discussion of *Tax Analysts v. Internal Revenue Service*, 350 F.3d 100 (D.C. Cir. 2003) in *Tax-Exempt Organizations* § 28.8(a)(ii), text accompanied by notes 245–252.

[19]The Tax Court was created in 1942; its predecessor was the Board of Tax Appeals. Some B.T.A. decisions still retain precedential value.

[20]This court was created (renamed) in 1982; its predecessor was the U.S. Claims Court.

[21]See § 3.13(b).

Most opinions emanating from a U.S. district court are published by the West Publishing Company in the ''Federal Supplement'' series (F. Supp. or F. Supp. 2d). Thus, a citation to one of these opinions appears as ''____ F. Supp. ____'' or ''____ Supp. 2d ____,'' followed by an identification of the court and the year of the opinion. The first number is the annual volume number, the other number is the page in the book on which the opinion begins (see, e.g., Chapter 1, note 165). Some district court opinions appear sooner in Commerce Clearinghouse or Prentice Hall publications (see, e.g., Chapter 3, note 304); occasionally, these publications will contain opinions that are never published in the Federal Supplement series.

Most opinions emanating from a U.S. court of appeals are published by the West Publishing Company in the ''Federal Reporter'' series (usually F.2d or F.3d). Thus, a citation to one of these opinions appears as ''____ F.2d ____''or ''____ F.3d ____,'' followed by an identification of the court and the year of the opinion. The first number is the annual volume number; the other number is the page in the book on which the opinion begins (see, e.g., Chapter 1, note 74). Appellate court opinions appear sooner in Commerce Clearinghouse or Prentice Hall publications (see, e.g., Chapter 3, note 310); occasionally, these publications contain opinions that are never published in the Federal Second or Federal Third series. Opinions from the U.S. Court of Federal Claims are also published in the Federal Second or Federal Third.

Opinions from the U.S. Tax Court are published by the U.S. government (Government Printing Office) and are usually in the form of ''regular opinions'' and cited as ''____ T.C. ____,'' followed by the year of the opinion (see, e.g., Chapter 3, note 308). Some Tax Court opinions that are of lesser precedential value (because they primarily involve determinations of fact and application of well-established rules of law) are published by the federal government as ''memorandum decisions'' and are cited as ''____ T.C.M. ____'' followed by the year of the opinion (see, e.g., Chapter 3, note 322). As always, the first number of these citations is the annual volume number, and the second number is the page in the book on which the opinion begins.[22] Commercial publishers publish regular opinions and memorandum decisions.[23]

U.S. district court and Tax Court opinions may be appealed to the appropriate U.S. court of appeals. For example, cases in the states of Maryland, North Carolina, South Carolina, Virginia, and West Virginia are appealable (from either court) to the U.S. Court of Appeals for the Fourth Circuit.[24] Cases from any federal appellate or district court, the U.S. Tax Court, and the U.S. Court of Federal Claims may be appealed to the U.S. Supreme Court.

[22]The IRS's practice is to not use ''*v. Commissioner*'' in citing U.S. Tax Court opinions. That convention is not followed in this book; ''Commissioner'' is referenced as ''Comm'r.''

[23]IRS examiners should not cite a Tax Court case in which the decision was against the government, unless the IRS has acquiesced in the decision (noted as ''Acq.'').

[24]The jurisdiction of each of the courts of appeal is provided in IRM 4.75.13-7.

District courts must follow the decisions of the court of appeals for the circuit in which they are located. If the court of appeals that is potentially involved in a case has not rendered a decision on a particular issue, the district court may reach its own decision or follow the decision of another circuit court that has rendered a decision on the issue. A circuit court is not bound by a decision of another circuit court.

The U.S. Supreme Court usually has discretion as to whether to accept a case.[25] This decision is manifested as a ''writ of certiorari.'' When the Supreme Court agrees to hear a case, it grants the writ (*cert. gr.*); otherwise, it denies the writ (*cert. den.*) (see, e.g., Chapter 3, note 341).

In this book, citations to Supreme Court opinions are to the ''United States Reports'' series, published by the U.S. government, when available (''____ U.S. ____ ,'' followed by the year of the opinion) (see, e.g., Chapter 1, note 74). When the United States Reports series citation is not available, the ''Supreme Court Reporter'' series, published by the West Publishing Company, reference is used (''____ S. Ct. ____ ,'' followed by the year of the opinion). As always, the first number of these citations is the annual volume number, the second number is the page in the book on which the opinion begins. There is a third way to cite Supreme Court cases, which is by means of the ''United States Supreme Court Reports—Lawyers Edition'' series, published by The Lawyers Co-Operative Publishing Company and the Bancroft-Whitney Company, but that form of citation is not used in this book. Supreme Court opinions appear earlier in the Commerce Clearinghouse or Prentice Hall publications.

In most instances, court opinions are available on Westlaw and LEXIS in advance of formal publication.

Decisions made at various levels of the court system are considered to be interpretations of the tax laws and may be used by examiners and taxpayers to support a position. Some court opinions lend more weight to a position than others. An opinion emanating from a case decided by the U.S. Supreme becomes the ''law of the land'' and takes precedence over decisions of lower courts. The IRS must follow Supreme Court decisions. In that sense, Supreme Court decisions have the same weight as the IRC. Decisions made by lower courts are binding on the IRS only for the particular taxpayer and the years litigated. Adverse decisions of lower courts do not require the IRS to alter its position for other taxpayers.

CITATORS

Whether the researcher is serving a taxpayer or the IRS, knowledge of the history of a tax law case is important; the research of case law is not complete until the history of a case is reviewed by means of a citator. Citators are

[25]The IRS observed that ''[o]nly a limited number of tax cases are heard'' by the Court (IRM 4.75.13.6.8.6 § 1).

published by commercial publishers, such as Commerce Clearing House, Inc. or Research Institute of America.

The researcher should consider whether a court opinion is current, whether there are other opinions on the same point that should be considered, or whether a decision remains valid. A citator lists court decisions alphabetically by name and shows where the text of the opinion may be found (citation). The citator traces the case history from its initial entry into the court system through consideration by the U.S. Supreme Court (should the case get that far).

A citator will show whether a higher court affirmed, reversed, modified, remanded, or otherwise disposed of a lower court opinion. If a lower court opinion is reversed by an appellate court or the Supreme Court, it loses its efficacy as a source of law.

As noted above, revenue rulings and revenue procedures may be revoked, modified, amplified, and the like. A citator findings list will indicate whether this has occurred with respect to a particular Rev. Rul. or Rev. Proc.

ACTION ON DECISIONS

It is the policy of the IRS to announce at an early date whether it will follow the holding(s) in certain court cases; such an announcement is an Action on Decision (AOD). An AOD is issued at the discretion of the IRS only on unappealed issues that have been decided adverse to the position of the government. Generally, an AOD is issued when guidance would be helpful to IRS personnel working with the same or similar issues. Unlike a tax regulation or a revenue ruling, an AOD is not an affirmative statement of the IRS's position. It is not intended to serve as guidance to the public and is not to be cited as precedent.

An AOD may be relied on within the IRS only as to the conclusion, applying the law to the facts in the particular case at the time the AOD was issued. IRS examiners are to exercise caution when extending the recommendation of an AOD to another case, where the facts may be different. An AOD may be superseded by legislation, regulations, rulings, court opinions, or a subsequent AOD.

An AOD may state that the IRS acquiesces in the holding of a court in a case and that the IRS will follow it in disposing of cases with the same facts; this *acquiescence* indicates neither approval nor disapproval of the reasons relied on by the court for its conclusions. An *acquiescence in result only* indicates IRS disagreement or concern with some or all of those reasons. *Nonacquiescence* signifies that, although no further review was sought, the IRS does not agree with the holding of the court and generally will not follow it in disposing of cases involving other taxpayers. With respect to an opinion of a circuit court of appeals, a nonacquiescence indicates that the IRS will not follow the holding on a nationwide basis; the IRS will, however, recognize the precedential

impact of the opinion on cases arising within the venue of the deciding circuit court.

AODs are published in the I.R.B. and thereafter in the appropriate C.B. An examiner is required to include in the citation to a court opinion any acquiescence (acq.), acquiescence in result only (acq. in result), or nonacquiescence (nonacq.).

STATE LAW

Legislative Branches

Statutory laws in the various states are created by their legislatures. There are no references to state statutory laws in this book (although most, if not all, of the states have such forms of law relating, directly or indirectly, to tax-exempt organizations).

Executive Branches

The rules and regulations published at the state level emanate from state departments, agencies, and the like. For tax-exempt organizations, these departments are usually the office of the state's attorney general and the state's department of state. There are no references to state rules and regulations in this book (although most, if not all, of the states have such forms of law relating to tax-exempt organizations).

Judiciary

Each of the states has a judiciary system, usually a three-tiered one modeled after the federal system. Cases involving nonprofit organizations are heard in all of these courts. There are no references to state court opinions in this book (although most, if not all, of the states have court opinions relating, directly or indirectly, to tax-exempt organizations).

State court opinions are published by the governments of each state and the principal ones by the West Publishing Company. The latter sets of opinions are published in ''Reporters'' relating to court developments in various regions throughout the country. For example, the ''Atlantic Reporter'' contains court opinions issued by the principal courts in the states of Connecticut, Delaware, Maine, Maryland, New Hampshire, New Jersey, Pennsylvania, Rhode Island, and Vermont, and the District of Columbia, while the ''Pacific Reporter'' contains court opinions issued by the principal courts of Arizona, California, Colorado, Idaho, Kansas, Montana, Nevada, New Mexico, Oklahoma, Oregon, Utah, Washington, and Wyoming.

PUBLICATIONS

Articles, of course, are not forms of the ''law.'' They can be cited, however, particularly by courts, in the development of the law. Also, as research tools, they contain useful summaries of the applicable law. In addition to the many law school ''law review'' publications, the following (not an inclusive list) periodicals contain material that is of help in following developments concerning tax-exempt organizations:

- *Bruce R. Hopkins' Nonprofit Counsel* (John Wiley & Sons, Inc.)
- *The Chronicle of Philanthropy*
- *Daily Tax Report* (Bureau of National Affairs, Inc.)
- *Exempt Organization Tax Review* (Tax Analysts)
- *Foundation News* (Council on Foundations)
- *The Journal of Taxation* (Warren, Gorham & Lamont)
- *The Journal of Taxation of Exempt Organizations* (Faulkner & Gray)
- *The Philanthropy Monthly* (Non-Profit Reports, Inc.)
- *Taxes* (Commerce Clearinghouse, Inc.)
- *Tax Law Review* (Rosenfeld Launer Publications)
- *The Tax Lawyer* (American Bar Association)
- *Tax Notes* (Tax Analysts)

APPENDIX B

IRS's ''Good Governance'' Principles (Draft)

SUMMARY OF PRINCIPLES

The IRS, on February 2, 2007, unveiled a draft of the agency's ''Good Governance Practices'' for charitable organizations. The occasion was a presentation by Marvin R. Friedlander, Chief, Exempt Organizations Technical Branch, Office of Rulings and Agreements.

The IRS is of the view that governing boards of charitable organizations should be composed of persons who are informed and active in overseeing the organizations' operations and finances. If a governing board tolerates a climate of secrecy or neglect, charitable assets are more likely to be used to advance an impermissible private interest. Successful governing boards include individuals who are not only knowledgeable and passionate about the organization's programs but also those with expertise in critical areas involving accounting, finance, compensation, and ethics.

Organizations with very small or very large governing boards may be problematic: Small boards generally do not represent a public interest; large boards may be less attentive to oversight duties. If an organization's governing board is very large, it may want to establish an executive committee with delegated responsibilities or establish advisory committees.

The IRS suggests that charitable organizations review and consider the following to help ensure that directors understand their roles and responsibilities, and actively promote good governance practices. While adopting a particular practice is not a requirement for tax exemption, the agency believes that an organization that adopts some or all of these practices is more likely to be successful in pursuing its exempt purposes and earning public support.

Here are the proposed Principles (essentially reproduced verbatim):

- *Mission statement.* A clearly articulated mission statement that is adopted by an organization's board of directors will explain and popularize the charity's purpose, and serve as a guide to the organization's work.

A well-written mission statement shows why the charity exists, what it hopes to accomplish, and what activities it will undertake, where, and for whom.

- *Code of ethics.* The public expects a charity to abide by ethical standards that promote the public good. The board of directors bears the ultimate responsibility for setting ethical standards and ensuring that they permeate the organization and inform its practices. To that end, the board should consider adopting and regularly evaluating a code of ethics that describes behavior it wants to encourage and behavior it wants to discourage. The code of ethics should be a principal means of communicating to all personnel a strong culture of legal compliance and ethical integrity.
- *Whistleblower policy.* The board of directors should adopt an effective policy for handling employee complaints and establish procedures for employees to report in confidence suspected financial impropriety or misuse of the charity's resources.
- *Due diligence.* The directors of a charity must exercise due diligence consistent with a duty of care that requires a director to act in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner the director reasonably believes to be in the charity's best interests. Directors should see to it that policies and procedures are in place to help them meet their duty of care, such as by (1) being familiar with the charity's activities and knowing whether the activities promote the charity's mission and achieve its goals, (2) being fully informed about the charity's financial status, and (3) having full and accurate information to make informed decisions.
- *Duty of loyalty.* The directors of a charity owe it a duty of loyalty. This duty requires a director to act in the interest of the charity rather than in the personal interest of the director or some other person or organization. In particular, the duty of loyalty requires a director to avoid conflicts of interest that are detrimental to the charity. To that end, the board of directors should adopt and regularly evaluate an effective conflict-of-interest policy that (1) requires directors and staff to act solely in the interests of the charity without regard for personal interests; (2) includes written procedures for determining whether a relationship, financial interest, or business affiliation results in a conflict of interest; and (3) prescribes a certain course of action in the event a conflict of interest is identified. Directors and staff should be required to disclose annually in writing any known financial interest that the individual, or a member of the individual's family, has in any business entity that transacts business with the charity.

- *Transparency.* By making full and accurate information about its mission, activities, and finances publicly available, a charity demonstrates transparency. The board of directors should adopt and monitor procedures to ensure that the charity's Form 990, annual reports, and financial statements are complete and accurate, are posted on the organization's public web site, and are made available to the public on request.
- *Fundraising policy.* Charitable fundraising is an important source of financial support for many charities. Success at fundraising requires care and honesty. The board of directors should adopt and monitor policies to ensure that fundraising solicitations meet federal and state law requirements and solicitation materials are accurate, truthful, and candid. Charities should keep their fundraising costs reasonable. In selecting paid fundraisers, a charity should use those that are registered with the state and that can provide good references. Performance of professional fundraisers should be continuously monitored.
- *Financial audits.* Directors must be good stewards of a charity's financial resources. A charity should operate in accordance with an annual budget approved by the board of directors. The board should ensure that financial resources are used to further charitable purposes by regularly receiving and reading up-to-date financial statements, including Form 990, auditor's letters, and finance and audit committee reports. If the charity has substantial assets or annual revenue, the board of directors should ensure that an independent auditor conduct an annual audit. The board can establish an independent audit committee to select and oversee the independent auditor. The auditing firm should be changed periodically (e.g., every five years) to ensure a fresh look at the financial statements. For a charity with lesser assets or annual revenue, the board should ensure that an independent certified public accountant conduct an annual audit. Substitute practices for very small organizations would include volunteers who would review financial information and practices. Trading volunteers between similarly situated organizations who would perform these tasks would also help maintain financial integrity without being too costly.
- *Compensation practices.* A successful charity pays no more than reasonable compensation for services rendered. Charities should generally not compensate persons for service on the board of directors, except to reimburse direct expenses of such service. Director compensation should be allowed only when determined to be appropriate by a committee composed of persons who are not compensated by the charity and have no financial interest in the determination. Charities may pay reasonable compensation for services provided by officers and staff.

- *Document retention policy.* An effective charity will adopt a written policy establishing standards for document integrity, retention, and destruction. The document retention policy should include guidelines for handling electronic files. The policy should cover backup procedures, archiving of documents, and regular checkups of the reliability of the system.

AUTHOR COMMENTARY

Throughout the course of the Charles Dickens novel, *A Tale of Two Cities*, Madame De Farge knits; she indefatigably knits. One can say with confidence she sticks to her knitting. According to the second edition of the *Dictionary of American Slang*, the phrase *stick to one's knitting* means to ''attend strictly to one's own affairs; not interfere with others; be singleminded.''

The mission of the IRS is to ''provide America's taxpayers with top quality service by helping them understand and meet their *tax* responsibilities and by applying the *tax law* with integrity and fairness to all'' (IRS web site and each issue of the weekly Internal Revenue Bulletin) (emphasis added). The mission of the Tax Exempt and Government Entities Division is the ''uniform interpretation and application of the *Federal tax laws* on matters pertaining to the Division's customer base'' (IRS web site) (emphasis added). The mission of the IRS and this Division is not to make pronouncements on ''good governance'' principles applicable (ostensibly or otherwise) to nonprofit organizations. The agency really should attend strictly to its own affairs; not interfere with others. The IRS should stick to its knitting.

There is nothing innovative in this list of charitable organizations' ''best practices'' for board governance. These elements have been hashed and rehashed by the Treasury Department's Anti-Terrorist Financing Guidelines, the Senate Finance Committee staff, Independent Sector's Panel on the Nonprofit Sector, and the Committee for Purchase from People Who Are Blind or Severely Disabled's proposed best practices, not to mention countless state court opinions, books, pamphlets, and articles.[1]

Some of the elements in this IRS package are unrealistic; a few are silly. Is the IRS going to interview board members to assess whether they are sufficiently ''passionate''? How many charitable boards include an individual who is an expert in ''ethics''? Whose ethics? How many boards have an expert on ''compensation''? How come the ''critical areas'' of board competence do not include law? (After all, the IRS wants to see a ''culture of legal compliance.'') Since when does the board of a charitable entity have to represent a ''public interest''? This is the first time that the concepts of executive and advisory committees are disparaged. (Usually, they are emblematic of good governance.)

[1]See *Tax-Exempt Organizations* § 5.6.

The IRS word police will be out, checking to see whether mission statements are ''clearly articulated'' and ''well-written'' (an expenditure of effort better directed at private letter rulings). It is not clear why the above-referenced conflict-of-interest policy does not apply to officers. It may be wondered how many state attorneys general agree with the notion that ''success at fundraising requires care and honesty.'' It is sufficient that fundraising materials be ''accurate'' and ''truthful''; being ''candid'' (whatever that may mean in this context) isn't required. Mandating five-year changes in auditing firms is not always a good idea; this goes way beyond legal requirements and the IRS's purview. The idea of ''trading volunteers'' is unrealistic and downright wacky; these individuals are not tradable at will and the proposal ignores why individuals volunteer in the first place. There is a total disconnect between a charity being ''successful'' and whether the compensation it pays is ''reasonable''; a charity can pay excessive compensation and still be successful. The advice about directors' compensation ignores explicit language in IRC § 501(q); expense reimbursement is not compensation. While a document retention policy is usually a good idea as an element of management, it is doubtful that it makes a charity more ''effective'' as a charity.

This is a major misstep on the part of the TE/GE Division. These good governance principles should be jettisoned. One, they add nothing of consequence to the body of information on the subject. Two, as noted, the IRS lacks the authority to poke around in this area. Three, too much of these principles is based on naïveté, nonsequiturs, and nonsensical statements. Fourth, and this is the most important, agents outside of Washington are going to ignore the word *suggestions* and begin imposing these governance elements as law when processing applications for recognition of exemption and auditing tax-exempt organizations. As to the last of these concerns, we have already seen this happen with respect to the matter of conflict-of-interest policies (which, not surprisingly, are mandated in these good governance principles).

Here is an agency that is way behind in the processing of applications for recognition of exemption, lacks the resources to timely respond to ruling requests, is overwhelmed by the need to issue guidance in connection with all of the new law provided by the Pension Protection Act, and is lagging in the provision of other needed guidance, such as comprehensive interpretation of the new tax shelter excise tax penalty rules. So, what does it do? Rather than devote time and energy to these important tasks, it wanders off into an area over which it has little or no jurisdiction, issues materials that are of no practical assistance if only because they are redundant of the efforts of others, and sets up the greatest of likelihoods that these proposals will be applied by IRS agents as if they are law as a condition of exemption. The IRS needs to abandon this project fast, to spare it further embarrassment and stem the spread of confusion in the field.

APPENDIX C

Synopsis of the Law of Tax-Exempt Organizations

Much more is required than the few pages of this appendix to summarize the federal law of tax-exempt organizations.[1] Nonetheless, the following synopsis of this body of law is provided to supply the reader (if necessary) with sufficient information to make this book a stand-alone volume.

I CATEGORIES OF TAX-EXEMPT ORGANIZATIONS

A. Single-Parent Title-Holding Corporations

Tax exemption is provided for subsidiary organizations that hold title to property that would otherwise be held by the parent tax-exempt organization (or two or more related exempt organizations) and remit any net income from the property to the parent (or parents).[2]

B. Charitable and Like Organizations

Tax exemption is provided for a variety of charitable organizations, including those that provide relief for the poor or distressed; promote health; lessen the burdens of government; advance education, science, or religion; promote social welfare; and promote youth sports and protection of the environment.[3] Exemption also is available for cruelty-prevention organizations, amateur sports organizations, public safety testing organizations, cooperative hospital service organizations, cooperative educational service organizations, and charitable risk pools.[4] Limitations apply as to private inurement, private benefit, and impermissible advocacy (namely, substantial legislative activities and any political campaign activity).[5]

[1]See, e.g., *Tax-Exempt Organizations*; *Planning Guide*.
[2]See *Tax-Exempt Organizations* § 19.2(a).
[3]*Id*., Chapter 7.
[4]*Id*., Chapter 11.
[5]*Id*., Chapters 20, 22, 23.

C. Religious Organizations

Tax exemption is provided for churches and similar institutions, conventions or associations of churches, integrated auxiliaries of churches, religious orders, apostolic organizations, and other religious organizations, including certain communal groups and retreat facilities.[6] Special rules apply as to IRS audits of churches.[7]

D. Private Schools

Tax exemption is provided for private schools, albeit with a variety of requirements, including the necessity of a disseminated policy as to nondiscrimination on the basis of race.[8] A *school* is an educational institution that has a regular faculty, a regularly enrolled student body, a curriculum, and a place where the educational activities are regularly carried on.

E. Public Interest Law Firms

Tax exemption is provided for certain types of public interest law firms. Restrictions apply as to the nature of the fees these firms can receive.[9]

F. Educational Organizations

Tax exemption is provided for formal educational organizations, such as schools, colleges, and universities, as well as for organizations that instruct individuals or the public. The term *educational* is not well defined; the federal tax law distinguishes it from *propagandizing*.[10]

G. Scientific Organizations

Tax exemption is provided to organizations that engage in scientific research in the public interest. There can be controversy as to whether an activity involves *research* as opposed to *commercial testing*.[11]

H. Amateur Athletic Sports Organizations

Tax exemption is provided to organizations that promote sports for the benefit of youth.[12]

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[6] *Id.*, Chapter 10.
[7] See Chapter 6.
[8] See *Tax-Exempt Organizations*, § 8.3(a).
[9] *Id.*, § 7.15(d).
[10] *Id.*, Chapter 8.
[11] *Id.*, Chapter 9.
[12] *Id.*, § 7.15(c).

I. Social Welfare Organizations

Tax exemption is provided to organizations that operate for the promotion of social welfare (such as civic leagues), in the sense of benefiting those in a community; this category of organizations may include advocacy organizations.[13]

J. Local Associations of Employees

Tax exemption is provided for local associations of employees, the membership of which is limited to the employees of a designated person in a particular municipality, where there is no private inurement.[14]

K. Labor Organizations

Tax exemption is provided for organizations that engage in collective action to better the working conditions of individuals engaged in a common pursuit. The principal type of this category of tax-exempt organization is the union.[15]

L. Agricultural and Horticultural Organizations

Tax exemption is provided for organizations that engage in activities to improve the grade of agricultural or horticultural products, and develop a higher degree of efficiency in the activity.[16]

M. Business Leagues

Tax exemption is provided for business leagues, namely, associations of persons united by common interests, as well as chambers of commerce, boards of trade, real estate boards, and professional football leagues.[17] The principal categories of tax-exempt organizations in this context are trade and business associations, and professional societies.[18]

N. Social Clubs

Tax exemption is provided for organizations that provide pleasure and recreation for the benefit of their members. These tax-exempt organizations, which include country clubs and hobby clubs, are required to pay tax on their net investment income.[19]

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[13] *Id.*, Chapter 13.
[14] *Id.*, § 19.3.
[15] *Id.*, § 16.1.
[16] *Id.*, §§ 16.2, 16.3.
[17] *Id.*, Chapter 14.
[18] See *Associations*.
[19] See *Tax-Exempt Organizations*, Chapter 15.

O. Fraternal Societies

Tax exemption is provided for fraternal beneficiary organizations operating under the lodge system and providing certain benefits to their members, and for domestic fraternal societies operating under the lodge system that devote their net earnings to charitable purposes.[20]

P. Voluntary Employees' Beneficiary Associations

Tax exemption is provided for associations that pay certain benefits to their members, or their dependents or designated beneficiaries.[21]

Q. Teachers' Retirement Fund Associations

Tax exemption is provided for teachers' retirement fund associations of a purely local character that pay retirement benefits to their members.[22]

R. Mutual and Cooperative Organizations

Tax exemption is provided for benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations.[23]

S. Cemetery Companies

Tax exemption is provided for cemetery companies, chartered solely for the purposes of burial or cremation, that are operated exclusively for the benefit of their members.[24]

T. Credit Unions

Tax exemption is provided for credit unions without capital stock that are operated for mutual purposes.[25]

U. Small Insurance Companies

Tax exemption is provided for insurance companies (other than life insurance companies) where the annual gross receipts of the company are limited and a set portion of the company's receipts are derived from premiums.[26]

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[20] *Id.*, § 19.4.
[21] *Id.*, § 18.3.
[22] *Id.*, § 18.7.
[23] *Id.*, § 19.5.
[24] *Id.*, § 19.6.
[25] *Id.*, § 19.7.
[26] *Id.*, § 19.9.

V. Crop Financing Organizations

Tax exemption is provided for corporations organized by an exempt farmers' cooperative to finance the ordinary crop operations of the members.[27]

W. Supplemental Unemployment Benefit Trusts

Tax exemption is provided for certain trusts forming part of a plan providing for the payment of supplemental unemployment compensation benefits.[28]

X. Veterans' Organizations

Tax exemption is provided for organizations of past or present members of the U.S. armed forces, or related auxiliaries or foundations, where at least 75 percent of the members are past or present members of the U.S. armed forces and substantially all of the other members are spouses or otherwise related to the members.[29]

Y. Black Lung Benefit Trusts

Tax exemption is provided for qualifying trusts used by coal mine operators to self-insure for liabilities under federal and state black lung benefits laws.[30]

Z. Multi-Parent Title-Holding Organizations

Tax exemption is provided for organizations operating for the exclusive purpose of holding title to real property, collecting income from the property, and remitting the net income to two or more qualified tax-exempt organizations.[31]

AA. Apostolic Organizations

Tax exemption is provided for religious or apostolic organizations that have a community treasury, even if they engage in business for the common benefit of their members, but only if the members include in their gross incomes their pro rata share of the organization's taxable income.[32]

BB. Political Organizations

Tax exemption is provided for parties, committees, associations, funds, and other organizations operated primarily for the purpose of accepting

[27] *Id.*, § 19.10.
[28] *Id.*, § 18.4.
[29] *Id.*, § 19.11.
[30] *Id.*, § 18.5.
[31] *Id.*, § 19.2(b).
[32] *Id.*, § 10.7.

contributions or making expenditures, usually for the purpose of assisting one or more individuals in getting elected to public office or preventing a candidate from becoming elected to a public office. These organizations are required to pay tax on their net investment income.[33]

CC. Health Maintenance Organizations

Tax exemption is available for a variety of organizations that provide health care services to their members on a prepaid basis and perhaps to nonmembers on a fee-for-service basis.[34]

DD. Cooperative Hospital Service Organizations

Tax exemption is available for certain cooperative organizations that are operated solely for the benefit of two or more tax-exempt member hospitals.[35]

EE. Cooperative Educational Service Organizations

Tax exemption is available for an organization that provides investment services to members that are private or public educational institutions.[36]

FF. Homeowners' Associations

Tax exemption is available for qualified homeowners' associations.[37]

II TAX-EXEMPT ORGANIZATIONS LAW BASICS

A. Organizational Test

The federal tax regulations contain an organizational test applicable to charitable organizations, which focuses on the content of an organization's statement of purposes and the necessity of a dissolution clause. Although there is no formal organizational test for any of the other types of tax-exempt organizations, these tests are inherent in each category of exemption.[38]

B. Operational Test

The federal tax regulations contain an operational test applicable to charitable organizations, which focuses on how an organization functions in relation to the applicable requirements for tax-exempt status. (These requirements

[33] *Id.*, Chapter 17.
[34] *Id.*, § 7.6(e), Chapter 13.
[35] *Id.*, § 11.4.
[36] *Id.*, § 11.5.
[37] *Id.*, § 19.14.
[38] *Id.*, § 4.3.

fundamentally are avoidance of private inurement, substantial legislative activity, and political campaign activity.) Although there is no formal operational test for any of the other types of tax-exempt organizations, these tests are inherent in each category of exemption.[39]

C. Primary Purpose Test

The primary purpose of an organization determines (in part) whether it can qualify as a tax-exempt organization and, if so, which category of exemption is applicable. The focus in this context is on purposes, not activities. Use of the term *exclusively* in the statutes has been interpreted by the courts to mean *primarily*.[40]

D. Private Inurement Doctrine

The doctrine of private inurement is one of the most important sets of rules constituting the federal law of tax-exempt organizations. This doctrine is a statutory criterion for federal income tax exemption for several categories of exempt organizations, including charitable entities.

The private inurement doctrine requires that a tax-exempt organization subject to it be organized and operated so that, in antiquated language, ''no part of . . . [its] net earnings . . . inures to the benefit of any private shareholder or individual.'' What this doctrine means is that none of the income or assets of a tax-exempt organization subject to the private inurement doctrine may be permitted to directly or indirectly unduly benefit an individual or other person who has a close relationship with the organization, when that person is in a position to exercise a significant degree of control over the entity.

The purpose of the private inurement rule is to ensure that the tax-exempt organization involved is serving exempt rather than private interests. It is thus necessary for an organization subject to the doctrine to be in a position to establish that it is not organized and operated for the benefit of persons in their private capacity, informally referred to as *insiders*, such as the organization's founders, trustees, directors, officers, members of their families, entities controlled by these individuals, or any other persons having a personal and private interest in the activities of the organization.

The doctrine of private inurement does not prohibit transactions between a tax-exempt organization subject to the doctrine and those who have a close relationship with it. Rather, the private inurement doctrine requires that these transactions be tested against a standard of *reasonableness*. The standard calls for a roughly equal exchange of benefits between the parties; the law is designed to discourage a disproportionate share of the benefits of the exchange flowing to an insider.

[39] *Id.*, § 4.5.
[40] *Id.*, § 4.4.

The private inurement doctrine does not prohibit the payment of compensation to employees of a charitable organization, provided the compensation is reasonable and not excessive. The reasonableness standard focuses essentially on comparability of data, that is, on how similar organizations, acting prudently, transact their affairs in comparable instances. Thus, the regulations pertaining to the business expense deduction, addressing the matter of the reasonableness of compensation, provide that it is generally just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances.

The sanction for violation of the private inurement doctrine is revocation (or denial) of the tax-exempt status of the organization involved.[41]

E. Private Benefit Doctrine

A tax-exempt organization's charitable status can be revoked if there is a finding that the organization is serving a private, rather than a public, benefit. To be exempt, a charitable organization must establish that it is not organized or operated for the benefit of private interests such as designated individuals, the organization's creator or the creator's family members, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

The prohibition against private benefit is not limited to situations where benefits accrue to an organization's insiders. An organization's conferral of benefits on ''disinterested persons'' (i.e., persons who are not insiders) may cause it to serve a private interest. Unlike the private inurement doctrine, the private benefit doctrine permits incidental private benefit. This is an important distinction, inasmuch as, technically, any amount of private inurement may jeopardize a charitable organization's tax-exempt status, while an incidental amount of private benefit is allowable.

The sanction for violation of the private benefit doctrine is revocation (or denial) of the tax-exempt status of the organization involved.[42]

F. Intermediate Sanctions Rules

The intermediate sanctions rules emphasize the taxation of persons who engaged in impermissible private transactions with certain types of tax-exempt organizations, rather than revocation of the tax-exempt status of these entities. With this approach, tax law sanctions—structured as penalty excise taxes—may be imposed on those persons who improperly benefited from the transaction and on certain managers of the organization who participated in the transaction knowing that it was improper. These taxes are applied to the

[41] *Id.*, Chapter 20.
[42] *Id.*, § 20.11.

amount of the excess benefit derived from the transaction. The taxes consist of an *initial* tax and an *additional* tax. The law as to excess benefit transactions applies with respect to tax-exempt public charities and exempt social welfare organizations. These entities are collectively termed, for this purpose, *applicable tax-exempt organizations*.

A person who has a close relationship with an applicable tax-exempt organization is a *disqualified person*. A disqualified person generally is a person who has, or is in a position to have, some type or degree of control over the operations of the applicable tax-exempt organization involved. The term *disqualified person* is defined under the intermediate sanctions rules as (1) any person who was, at any time during the five-year period ending on the date of the transaction involved, in a position to exercise substantial influence over the affairs of the organization (whether by virtue of being an organization manager or otherwise), (2) a member of the family of an individual described in the preceding category, and (3) an entity in which individuals described in the preceding two categories own more than a 35 percent interest.

At the heart of the intermediate sanctions regime is the *excess benefit transaction*. In general, an excess benefit transaction is a transaction in which an economic benefit is provided by an applicable tax-exempt organization, directly or indirectly, to or for the use of a disqualified person, and the value of the economic benefit provided by the organization exceeds the value of the consideration (including the performance of services) received for providing the benefit. The difference between the value provided by the exempt organization and the consideration (if any) it received from the disqualified person is an *excess benefit*.

An excess benefit transaction includes a payment of unreasonable (excessive) compensation by an applicable tax-exempt organization to a disqualified person with respect to it. The value of services, in the intermediate sanctions setting, is the amount that ordinarily would be paid for like services by like organizations under like circumstances. Compensation in this context includes all economic benefits (other than certain disregarded benefits) provided by an applicable tax-exempt organization, to or for the use of a person, in exchange for the performance of services, including all forms of cash and noncash compensation.

The intermediate sanctions rules entail an initial tax, which is 25 percent of the excess benefit, payable by the disqualified person or persons involved. The transaction must be undone, by placing the parties in the same economic position they were in before the transaction was entered into; this is ''correction'' of the transaction. If the initial tax is not timely paid and the transaction is not timely and properly corrected, an additional tax may have to be paid; this tax is 200 percent of the excess benefit.[43]

[43] *Id.*, Chapter 21.

G. Commensurate Test

Pursuant to an infrequently used commensurate test, the IRS may assess whether a charitable organization is maintaining program activities that are commensurate in scope with its financial resources.[44]

H. Public Policy Doctrine

Tax exemption as a charitable organization is available only where the organization is operating in conformance with federal public policy. For example, pursuant to this body of law, a private school cannot be tax-exempt if it has a racially discriminatory policy as to the admission of students.[45]

III LEGISLATIVE ACTIVITIES LAW

A. Charitable Organizations

Tax-exempt public charities may engage in legislative activities to the extent that lobbying is not a *substantial* part of their overall functions. This rule is known as the *substantial part test*. A mechanical test for measuring allowable lobbying, the *expenditure test*, may be elected. Excessive lobbying may lead to the imposition of excess taxes and/or revocation of exemption.[46] More stringent rules are applicable to private foundations.[47]

B. Social Welfare Organizations

There are no federal tax law limitations on attempts to influence legislation by tax-exempt social welfare organizations, other than the general requirement that the organization primarily engage in efforts to promote social welfare.[48]

C. Associations (Business Leagues)

There are no federal tax law limitations on attempts to influence legislation by tax-exempt business leagues, other than the general requirement that the organization primarily engage in activities appropriate for these organizations. The federal tax law, however, includes rules restricting the tax deductibility of dues paid to these organizations to the extent a portion of the dues is used for lobbying.[49]

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[44] *Id.*, § 4.7.
[45] *Id.*, § 6.2.
[46] *Id.*, Chapter 22.
[47] See *Private Foundations* § 9.1.
[48] See *Tax-Exempt Organizations* § 22.5.
[49] *Id.*, § 22.6.

D. Other Exempt Organizations

There are no federal tax law limitations on attempts to influence legislation by any other types of tax-exempt organizations, other than the general requirement that the organization primarily engage in efforts to advance its exempt purpose.[50]

IV POLITICAL ACTIVITIES LAW

A. Charitable Organizations

A charitable organization, to be tax-exempt, may not participate or intervene in a political campaign on behalf of or in opposition to a candidate for public office. This is an absolute prohibition. Political activity may lead to the imposition of excess taxes and/or revocation of exemption.[51] More stringent rules are applicable to private foundations.[52]

B. Social Welfare Organizations

A tax-exempt social welfare organization can engage in political campaign activity, without jeopardizing its exemption, but this type of activity cannot be its primary function.[53]

C. Associations (Business Leagues)

There are no federal tax law limitations on political campaign activity by tax-exempt business leagues, other than the general requirement that the organization primarily engage in activities appropriate for these organizations. The federal tax law, however, includes rules restricting the tax deductibility of dues paid to these organizations to the extent a portion of the dues is used for political activity.[54]

D. Political Organizations

Most political organizations have as their primary exempt function the involvement in political campaign activity, either in support of or in opposition to one or more candidates for public office.[55]

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[50] *Id.*, § 22.7.
[51] *Id.*, §§ 23.1–23.4.
[52] See *Private Foundations* § 9.2.
[53] See *Tax-Exempt Organizations* § 23.5.
[54] *Id.*, § 23.7.
[55] *Id.*, Chapter 17.

E. Other Exempt Organizations

The federal tax law is silent as to the extent to which other tax-exempt organizations can engage in political campaign activity, in relation to their eligibility for exempt status. The primary purpose rule applies.[56]

V PUBLIC CHARITIES AND PRIVATE FOUNDATIONS

A. Rebuttable Presumption

Every tax-exempt charitable organization is presumed to be a *private foundation*, a term that is not expansively defined in the federal tax law. This presumption may be rebutted by a showing that the entity is a *public charity*. Thus, a private foundation is an exempt charitable organization that is not a public charity. Generically, a private foundation is a charitable entity that is funded from one source, has ongoing funding in the form of investment income, and makes grants for charitable purposes.[57]

B. Institutions

Certain *institutions* are classified as public charities. The principal types of institutions are churches, formal educational institutions, hospitals, medical research organizations, and governmental units.[58]

C. Publicly Supported Organizations

Publicly supported charitable organizations are forms of public charities. The *donative* type of publicly supported charity normally receives a substantial part of its support (other than exempt function revenue) in the form of contributions or grants from the public or one or more governmental units. The *service provider* type of publicly supported charity normally receives more than one-third of its support in the form of contributions, grants, membership fees, and fee-for-service revenue from *permitted sources*, and normally does not receive more than one-third of its support in the form of gross investment income and net unrelated business income.[59]

D. Supporting Organizations

Supporting organizations are forms of public charities. Essentially, a *supporting organization* must be organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more qualified supported organizations. Typical functions of a supporting

[56] *Id.*, § 23.8.
[57] *Id.*, § 12.1(a).
[58] *Id.*, § 12.3(a).
[59] *Id.*, § 12.3(b).

organization are fundraising, operation of separate programs, and maintenance of an endowment fund. There are four basic types of supporting organizations: Type I, II, or III (either functionally integrated or not).[60]

E. Public Safety Testing Organizations

A public safety testing organization is a form of public charity.[61]

F. Private Foundation Rules

Private foundations are subject to a battery of rules prohibiting self-dealing with disqualified persons,[62] excess business holdings, jeopardizing investments, taxable expenditures, and mandating a certain income payout.[63] The sanctions for violating these rules include a series of excise taxes.[64] These taxes are reported on Form 4720.

VI EXEMPTION RECOGNITION PROCESS

A. In General

Tax exemption for qualified organizations is available as a matter of law. Most charitable organizations, certain employee benefit organizations, and credit counseling organizations that desire exemption as social welfare organizations, however, are required, to be exempt, to have their exempt status *recognized* by the IRS, by issuance of a determination letter or ruling. Other organizations may, but are not required to, file an application for recognition of exemption with the IRS. For charitable organizations, this application is on Form 1023; for most other exempt organizations, the application is on Form 1024.[65] Political organizations must, to be exempt, file a *notice* with the IRS (Form 8871).[66]

B. Group Exemption

Additional rules apply with respect to *group exemptions*. This is a regime by which organizations that are affiliated with a central tax-exempt organization can be exempt without applying to the IRS for recognition of exemption.[67]

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[60] *Id.*, § 12.3(c).
[61] *Id.*, § 12.3(d).
[62] *Id.*, § 12.2.
[63] See *Private Foundations*, Chapters 5–9.
[64] See *Tax-Exempt Organizations*, § 12.4.
[65] *Id.*, Chapter 25.
[66] *Id.*, § 25.8.
[67] *Id.*, § 25.6.

VII REPORTING RULES

A. Annual Information Returns

Nearly every organization that is exempt from federal income taxation is required to annually file an information return with the IRS. For most tax-exempt organizations, this return is Form 990.[68] Small exempt organizations can file Form 990-EZ.[69] Private foundations file Form 990-PF.[70] Homeowners' associations file Form 1120-H; black lung benefit trusts file Form 990-BL. There are some exceptions to this filing requirement.[71]

B. Political Organizations Returns

Political organizations may file Form 990 and/or 1120-POL.[72]

C. Unrelated Business Income Returns

A tax-exempt organization with unrelated business income is required to file an income tax return, reporting the income, expenses, and any tax due (Form 990-T).[73]

D. Split-Interest Trust Returns

A split-interest trust is required to annually file a return (generally Form 1041A) with the IRS.[74]

E. Nonexempt Charitable Trust Returns

A nonexempt charitable trust is required to annually file a return (Form 1041A) with the IRS.[75]

F. Apostolic Organizations' Returns

Apostolic organizations are required to annually file a partnership return with the IRS (Form 1065).

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[68] *Id.*, § 27.2(a)(i)–(iii).
[69] *Id.*, § 27.2(a)(iv)
[70] *Id.*, § 27.2(a)(v).
[71] *Id.*, § 27.2(b).
[72] *Id.*, § 27.5.
[73] *Id.*, § 27.7. Also *Unrelated Business* § 11.4.
[74] See *Charitable Giving* § 21.3A.
[75] *Id.*

VIII DISCLOSURE RULES

A. Application for Recognition of Exemption

In general, a tax-exempt organization is required to make available to the public copies of its application for recognition of exemption (if any) (e.g., Form 1023) and supporting documents.[76]

B. Annual Information Returns

In general, a tax-exempt organization is required to make available to the public copies of its three most recent annual information returns (if any) (e.g., Form 990).[77]

C. Unrelated Business Income Returns

Tax-exempt organizations must make available to the public copies of their unrelated business income tax returns (if any) (Form 990-T).[78]

D. Disposition of Gift Property Rules

A charitable organization that disposes of charitable gift property within two years of the date of the gift is generally required to report the transaction (on Form 8282) to the IRS.[79]

IX UNRELATED BUSINESS RULES

A. Requirement of Business

A *business* of a tax-exempt organization is an activity that is carried on for the production of income from the sale of goods or the performance of services.[80] Businesses of exempt organizations are either related[81] or unrelated.[82]

B. Regularly Carried On Rule

A business of a tax-exempt organization, to be considered an unrelated business, must be regularly carried on.[83] Generally, this element of

[76] *Id.*, § 27.9.
[77] *Id.*
[78] *Id.*, § 27.7.
[79] See *Charitable Giving* § 21.3.
[80] See *Tax-Exempt Organizations* § 24.2(a).
[81] *Id.*, e.g., § 24.4(f).
[82] *Id.*, e.g., § 24.4(g).
[83] *Id.*, § 24.3.

regularity is measured annually; if a season is involved, that is the measuring period.

C. Substantially Related Standard

A business of a tax-exempt organization is considered a related business where the conduct of the business activity has a causal relationship to the achievement of an exempt purpose (other than through the production of income) and the causal relationship is substantial.[84]

D. Exceptions as to Activities

Various exceptions from treatment as unrelated business are available for activities of tax-exempt organizations, including volunteer-conducted businesses, convenience businesses, sales of gift items, certain entertainment activities, the conduct of trade shows, certain hospital services, the dissemination of low-cost articles, and the exchanging or rental of mailing lists.[85]

E. Exceptions as to Income

Various exceptions (in the form of *modifications* of the general rule) from treatment as unrelated business income are available for income received by tax-exempt organizations, including dividends, interest, annuities, royalties, rent, capital gains, and research income.[86]

F. Social Clubs and Like Organizations' Rules

Special unrelated business rules are applicable to social clubs, veterans' organizations, voluntary employees' beneficiary associations, and supplemental unemployment benefit trusts.

G. Unrelated Debt-Financed Income Rules

In computing a tax-exempt organization's unrelated business taxable income, there must be included with respect to each debt-financed property that is unrelated to the organization's exempt function—as an item of gross income derived from an unrelated trade or business—an amount of income from the property subject to tax in the proportion to which the property is financed by the debt.[87]

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[84] *Id.*, § 24.4.
[85] *Id.*, § 24.7.
[86] *Id.*, § 24.6.
[87] *Id.*, § 24.12.

H. Tax Computation

The unrelated income tax rates payable by most tax-exempt organizations are the corporate rates.[88] In computing unrelated business taxable income, exempt organizations may deduct expenses that are directly connected with the carrying on of the trade or business.[89] A specific deduction is available,[90] as is a charitable deduction.[91]

X SUBSIDIARIES

Tax-exempt organizations may have subsidiaries. Some of these subsidiaries may be tax-exempt, such as supporting organizations and lobbying arms of public charities.[92] These subsidiaries may be for-profit, taxable entities, usually utilized to conduct substantial unrelated business.[93] In some instances, revenue received by an exempt organization parent from its subsidiary is taxable as unrelated business income.[94]

XI JOINT VENTURES

Tax-exempt organizations may participate in partnerships and other forms of joint ventures, such as those utilizing limited liability companies.[95] Most of the law in this area concerns public charities as general partners or members in these ventures.[96] Ventures may be whole-entity or ancillary.[97] The IRS is particularly sensitive to the potential for private inurement or private benefit in these circumstances.[98]

XII OTHER ASPECTS OF LAW OF EXEMPT ORGANIZATIONS

A. Gaming

In general, the conduct of gaming (or gambling) activity by a tax-exempt organization constitutes an unrelated business or a nonexempt function that may jeopardize the organization's exempt status. An exception in the unrelated

[88] *Id.*, § 24.13.
[89] *Id.*, § 24.14.
[90] *Id.*, § 24.6(r).
[91] *Id.*, § 24.6(q). In general, see *Unrelated Business*.
[92] See *Tax-Exempt Organizations*, Chapter 28.
[93] *Id.*, Chapter 29.
[94] *Id.*, §§ 28.6, 29.7.
[95] *Id.*, § 30.1.
[96] *Id.*, § 30.2.
[97] *Id.*, §§ 30.3, 30.4.
[98] *Id.*, e.g., § 20.11(b).

business context is available for the conduct of bingo games, where they are lawful under state law.[99]

B. Unemployment Tax

Tax-exempt organizations generally are required to pay the federal unemployment tax.[100]

C. Nonexempt Membership Organizations

Special rules apply that can limit the deductibility of expenses in computing taxable income in situations where a nonprofit organization is a nonexempt membership entity.[101]

D. Maintenance of Books and Records

Tax-exempt organizations are required to keep records sufficiently showing gross income, expenses, and disbursements, and providing substantiation for their annual information returns.[102]

E. Personal Benefit Contracts

The federal tax law denies a charitable contribution deduction in connection with, and imposes penalties on tax-exempt organizations that engage in transactions involving, certain personal benefit contracts.[103]

F. Commerciality Doctrine

Tax-exempt organizations, particularly public charities that operate in a commercial manner (i.e., in the same manner as for-profit entities), may have their exemption revoked.[104] Commercial activity may alternatively be considered an unrelated business.[105] Factors as to commerciality include the extent of the sale of goods and services to the public, pricing policies, and competition with for-profit businesses.

XIII CHARITABLE GIVING RULES

A. Charitable Deduction

The federal tax law provides for an income tax charitable contribution deduction for gifts to charitable and certain other types of tax-exempt

[99] *Id.*, § 24.7(h).
[100] IRC §§ 3301–3311.
[101] See *Tax-Exempt Organizations* § 19.23.
[102] *Id.*, § 27.17.
[103] *Id.*, § 27.12(d).
[104] *Id.*, § 4.11.
[105] *Id.*, §§ 24.4(h), 24.11.

organizations.[106] These deductible contributions may be made in the form of money or property.[107] Various percentage limitations may restrict the amount of a charitable contribution deduction in a year.[108] Many special rules apply in this context for particular types of charitable gifts, such as those of inventory, scientific research property, vehicles, and intellectual property.[109] Charitable deductions are also available in conjunction with the federal estate and gift taxes.[110]

B. Property Valuation

In connection with charitable contributions of property, often the major issue affecting the deductibility of the gift is the matter of the fair market value of the property at the time of its contribution.[111] Various penalties can apply with respect to an overvaluation of property in this context.[112]

C. Gift Restrictions

A gift may be made to charity that involves the imposition of conditions or restrictions. In many instances, such a restriction is lawful (such as for scholarships, a form of research, or for an endowment).[113] A restriction or condition may, however, be unlawful, may result in unwarranted private benefit,[114] or reduce or eliminate the amount of the allowable charitable deduction.[115]

D. Split-Interest Trusts

Contributions may be made to charity by means of a split-interest trust.[116] The resulting charitable contribution deduction (if any) is based on the value of the partial interest contributed.[117] For a charitable deduction to be available in this context, various requirements must be satisfied, such as those for charitable remainder trusts,[118] pooled income funds,[119] and other types of gifts of remainder interests.[120]

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[106]See *Charitable Giving*, Chapters 1, 3.
[107]*Id.*, Chapter 4.
[108]*Id.*, Chapter 7.
[109]*Id.*, §§ 9.3, 9.4, 9.25, 9.26.
[110]*Id.*, Chapter 8.
[111]*Id.*, § 10.1.
[112]*Id.*, § 10.14.
[113]*Id.*, § 10.4.
[114]*Id.*, e.g., § 10.5.
[115]*Id.*, §§ 18.3, 22.2.
[116]*Id.*, § 5.3.
[117]*Id.*, §§ 9.23, Chapter 11.
[118]*Id.*, Chapter 12.
[119]*Id.*, Chapter 13.
[120]*Id.*, Chapter 15.

E. Nonexempt Charitable Trusts

The federal tax law provides special rules for certain nonexempt charitable trusts; these entities are usually subject to one or more of the private foundation rules.[121]

XIV FEDERAL LAW AS TO FUNDRAISING

A. Special Events

Special events are social occasions (such as annual balls, games of chance, and sports events) for the benefit of charities that use ticket sales and underwriting to generate revenue.[122] These events, however, may raise federal tax law issues, such as unrelated business and inappropriate gaming.

B. Gift Substantiation Rules

For a charitable contribution of $250 or more to be deductible, certain substantiation requirements must be met. This principally entails a written communication from the charitable donee to the donor, containing specified information.[123] Other charitable gift substantial rules may arise in other contexts, such as with respect to contributions of vehicles[124] or intellectual property.[125]

C. Quid Pro Quo Contribution Rules

The federal tax law imposes certain disclosure requirements on charitable organizations that receive *quid pro quo contributions*, which are payments made partially as a contribution and partially in consideration for goods or services provided by the donee organization. Penalties apply for violation of these rules.[126]

D. Noncharitable Organizations Gifts Disclosure

The federal tax law imposes certain disclosure requirements in connection with contributions to tax-exempt organizations other than charitable entities. These rules, targeted principally at exempt social welfare organizations, are designed to prevent circumstances where donors are led to believe that the gifts are deductible when they are not. Penalties apply for violation of these rules.[127]

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[121] See *Private Foundations* § 3.6.
[122] See *Charitable Giving* § 23.2.
[123] *Id.*, § 21.1(b).
[124] *Id.*, § 9.25.
[125] *Id.*, § 9.26.
[126] *Id.*, § 22.2.
[127] *Id.*, § 22.3.

E. Appraisal Requirements

A contribution deduction is not available, in an instance of a gift of property with a value in excess of $5,000, unless certain appraisal requirements are satisfied, including an obtaining by the donor of a *qualified appraisal*, the preparation of an *appraisal summary*, and use of the services of a *qualified appraiser*.[128]

[128] *Id.*, § 21.2.

APPENDIX D

Exempt Organizations Fiscal Year 2008 Implementing Guidelines Summary

As this book was completing production, the IRS, on December 13, 2007, announced issuance of the Exempt Organizations Fiscal Year 2008 Implementing Guidelines. These guidelines, summarized in this appendix, contain considerable material about the agency's examination plans during this fiscal year.

The guidelines proclaimed that the Exempt Organizations Division ''has a new way of doing business.'' The agency said it is ''now bring[ing] a flexible and interdisciplinary array of new tools and talent to bear on the critical issues and opportunities that confront us in working toward our strategic goals: (1) to enhance the enforcement of the tax law, and (2) to improve customer service.''

FY 2008 PLANS – ENFORCEMENT

With the advent of fiscal year 2008, the IRS is adding three new compliance tools. One of these tools is participation in the National Research Program (NRP). The NRP is a ''comprehensive effort by the IRS to measure compliance for different types of taxes and various sets of taxpayers.'' This program, which provides a ''statistically valid representation of the compliance characteristics of taxpayers,'' has been used to date by the agency to measure ''compliance and the tax gap'' in connection with individuals and for-profit businesses.

The NRP currently includes development of a ''Servicewide reporting compliance study for employment taxes, which will involve all employment tax filers, including exempt organizations and government entities.'' The Exempt Organizations Division is said to be ''committed to supporting the design and delivery'' of this study.

The second compliance effort is conduct of a research and compliance initiative involving tax-exempt colleges and universities, similar to the one undertaken concerning exempt hospitals. During FY 2008, the IRS ''will gather information from a stratified sampling of colleges and universities to gain a

better understanding of this important sector,'' by means of dissemination of a compliance check questionnaire. In particular, the IRS will look at how colleges and universities:

- Report income and expenses on their annual information returns (Form 990).
- Calculate and report losses on their unrelated business income tax returns (Form 990-T).
- Allocate income and expenses in calculating their unrelated business taxable income.
- Determine executive compensation.
- Invest and use their endowments.

The third of these compliance tools will be development of a voluntary compliance program in connection with the law enacted in 2006, pursuant to which organizations can automatically lose their tax-exempt status for failing to file, for three consecutive years, annual information returns or notices. This program will enable organizations to avoid this revocation by ''filing the missing returns and paying all taxes and applicable interest, without facing any penalties.''

The IRS will also be looking at recently created supporting organizations, ''some established by promoters.'' The Review of Operations unit (ROO) will begin examining 500 supporting organizations that are in their third to fifth year of existence to determine if they continue to qualify. The IRS will also conduct compliance checks of 300 supporting organizations that were expected to file an annual information return but did not.

The IRS will continue to examine charitable remainder trusts that that did not distribute their assets to charity in their final year. The agency will also examine these trusts as to their first year to determine if they were properly established and if the charitable deduction was correctly calculated. The IRS further is continuing to examine non-exempt charitable trusts, with taxable income, that filed an annual information return but not a Form 1041.

The IRS has commenced examinations of organizations that may be promoting overvaluations of conservation and façade easement gifts. This effort will continue in FY 2008. The IRS will develop a conservation easements determination guide sheet, to assist determination specialists with direction as to what to look for when reviewing applications for recognition of exemption in this context and to help the public understand the IRS' thinking on these issues.

Another area that the IRS will be reviewing is operation of business franchises and participation in business ventures with for-profit entities by tax-exempt organizations. Questions the agency will be seeking answers to include:

- Is the franchise or venture part of the exempt organization's mission or is it an unrelated business?
- Does the scope of the franchise or venture have an adverse impact on the organization's exempt status?
- Does the franchise pay reasonable compensation, and properly report and withhold employment taxes?

Other compliance projects that will be ongoing in FY 2008 are the Political Activity Compliance Initiative, an outreach effort to provide guidance as to permissible political activity by tax-exempt social welfare organizations, the Executive Compensation Compliance Project, evaluation of the questionnaires sent as part of the community foundations compliance check project (which is expected to lead to approximately 100 examinations), review of organizations that conduct gaming, and completion of the compliance check project concerning entities that are claiming to be *qualified state or local political organizations* (and thereby exempt from filing Form 8872).

FY 2008 PLANS – CUSTOMER SERVICE

The IRS is developing and implementing an electronic determinations case processing and tracking system – the TE/GE Determination System (TEDS). TEDS, the IRS wrote, will give the agency the ''ability to store, assign, and eventually process application files in a totally online environment, making paper files a thing of the past.'' In FY 2008, TEDS ''will pilot the scanning of incoming applications and paper case files to create electronic case files that are processed by technical screeners.'' The TEDS process is intended to ''simplify the generation of determination letters and expedite the closing of cases.''

The IRS continues to work on its Cyber Assistant program. This is a ''web-based tool that will guide an applicant through the application [for recognition of exemption] process while educating the applicant about the duties and responsibilities that go along with tax-exempt status.'' This program ''solicits information about the applicant and builds an exemption [recognition] application based on the user's responses,'' and it ''alerts the user to errors in the application and prompts the user to supply missing information.'' The final product will be a completed application that can be printed and mailed to the IRS, along with printed barcodes that will help in processing the application in TEDS. A pilot version of the Cyber Assistant is to be tested in FY 2008.

NEW WAYS OF ENFORCEMENT

The IRS reports that it has ''new business processes that broaden and strengthen'' its ''enforcement presence.'' The agency has assembled a Strategic Planning Working Group, comprised of representatives from the Exami-

nations, Rulings and Agreements, and Customer Education and Outreach functions. This group ''identifies potential areas of noncompliance using data mining, trend research, and analysis,'' then proposes projects to the Division executives who select the ''most compelling compliance issues'' for inclusion in the Division's workplan. Thereafter, a Compliance Strategies and Critical Initiatives Group ''develops a compliance strategy, oversees the selected projects, and periodically reports on the progress of the projects to the executives.''

One of the IRS' ''most effective'' compliance project tools is its *compliance check program*. This program enables the agency to ''gather information from a large number of organizations about their activities by using letters and questionnaires rather than resource-intensive examinations.'' The resulting information is used to identify compliance problems and to ''fashion the most appropriate strategy for addressing them – from educational outreach to new guidance to examinations to follow-up'' by the ROO. Recommendations from these compliance check projects are used ''as the foundation on which to build [the IRS'] strategic plan for future years.''

NEW FORMS OF CUSTOMER SERVICE

The IRS' ''expanded vision'' of customer service is predicated on uses of computers to get information to and from the agency, as reflected in its efforts to:

- Develop and implement an electronic case processing system that is intended to shorten the time it takes the IRS to process applications for recognition of exemption (see below).
- Develop a computer program that guides users through the application for recognition of exemption process and generates a completed application (the Cyber Assistant).
- Implement a ''simple and cost-free'' e-Postcard program for small exempt organizations to use in transmitting their annual notices.
- ''[H]arness the power of the Internet to conduct workshops and deliver educational material.''

FY 2007 ACCOMPLISHMENTS – ENFORCEMENT

The IRS' ''top priority'' in fiscal year 2007 was implementation of many of the provisions of the Pension Protection Act of 2006 (PPA). The accomplishments in this connection were:

- Development of a procedure by which supporting organizations can change their public charity status to escape compliance with the PPA-enacted requirements.

- Development of a due diligence process for private foundations and sponsors of donor-advised funds to follow in making grants to supporting organizations.
- Issuance of guidance concerning the requirements that charitable organizations make their unrelated business income tax returns (Form 990-T) publicly available.
- Revision of forms (990, 990-PF, 990-T. 4720, 8282) and related instructions to reflect PPA law changes.
- Mailing of 10,237 letters to small supporting organizations reminding them that they now must file annual information returns.
- Design of the e-Postcard program.

Another area of accomplishment concerns the rules pertaining to tax-exempt organizations' involvement in prohibited tax shelter transactions, created by enactment of the Tax Increase Prevention and Reconciliation Act of 2005. Accomplishments:

- Issuance of guidance as to when an exempt entity is a *party* to such a transaction, allocation of net income or proceeds of a transaction to a tax year, and treatment of net income or proceeds received before this law's effective date.
- Temporary regulations on disclosure requirements for exempt entities that are parties to proposed tax shelter transactions.
- Temporary and final regulations relating to timing and return requirements for the excise tax (IRC § 4965) payments.
- Proposed regulations relating to excise tax and disclosure requirements relating to these transactions.
- Commencement of examinations of organizations that may have received *successor member interests* in real property (also known as *transactions of interest*).
- Other FY 2007 accomplishments:
- Redesign of the Form 990.
- Continuation of the Political Activity Compliance Initiative, including formal guidance on the political campaign prohibition on public charities.
- Continuation of the Executive Compensation Compliance Project.
- Continuation of the Tax-exempt Hospitals Compliance Project.
- Continuation of the program of examining, and denying recognition of exemption to, or revoking exemption of, credit counseling organizations.

- Continuation of the program of examining, and denying recognition of exemption to, or revoking exemption of, down-payment assistance organizations.
- Compliance checks concerning payment and reporting of employment taxes.

FY 2007 ACCOMPLISHMENTS – CUSTOMER SERVICE

The accomplishments of the IRS in the area of customer service in FY 2007 were the following:

- Issuance of over 90,000 determination letters.
- Reduction in the unassigned inventory of applications for recognition of exemption (from 8,693 to 5,625).
- Reduction in the assigned inventory of these applications by 27 percent (6,544).
- Reduction in the average time to assign an application case (from 7 to 3 months).
- Reduction in the average application processing time (by 12 days).
- Guidance as to the e-Postcard program.
- Implementation of the program of sharing information with state officials.
- Growth of web-based training offerings.

Table of Cases

Table of IRS Revenue Rulings

Table of IRS Revenue Procedures

Revenue Procedures	Sections
68–16	§ 1.10(b)
78–9	§ 3.13(a)
79–63	§ 3.13(b)(ii)
80–28	§ 3.13(c)
94–69	§ 3.7
2007–2	§ 1.9
2007–5	§§ 1.9, 1.9(a)–1.9(k)
2007–52	§§ 2.2, 2.3(a), 2.11, 3.13, 3.13(b)(i), 3.13(b)(ii)

Index