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The IRS Final Report on Nonprofit Colleges and Universities: Lessons for All Tax-Exempt Organizations

October 24, 2013

Venable LLP

Washington, DC

Moderator:

Jeffrey S. Tenenbaum, Esq., Venable LLP

Panelists:

Matthew T. Journy, Esq., Venable LLP

Margaret C. Rohlfing, Esq., Venable LLP

Presentation

The IRS Final Report on Nonprofit Colleges and Universities: Lessons for All Tax-Exempt Organizations

Thursday, October 24, 2013, 12:30 p.m. – 2:00 p.m. ET

Venable LLP, Washington, DC

Moderator:
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Upcoming Venable Nonprofit Legal Events

November 14, 2013 – Donor Intent, Restricted Funds, and Gift Acceptance Policies: What Every Nonprofit Needs to Know to Effectively Accept and Utilize Contributions

December 5, 2013 – Work & Family: What Nonprofit Employers Should Know about Family-Oriented Employment Laws

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Overview

- IRS Enforcement
- Compliance Projects
- The Colleges and Universities Compliance Project
  - Timeline
  - Final Report
- Lessons to Be Learned from the Final Report
  - Tax-Exempt Colleges and Universities
  - All Tax-Exempt Organizations

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Compliance Projects

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Compliance Projects

- What is a Compliance Project?
  - New method of conducting examinations where the IRS reviews the largest and most complex tax-exempt organizations.
  - Through a compliance project, the IRS will:
    - Consider the tax compliance issues that are unique to an entire industry;
    - Learn about the industry and identify common areas of potential noncompliance within the industry; and
    - Develop a methodology for training IRS agents to identify and develop facts related to the identified issues.

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Compliance Projects (cont'd.)

- Compliance projects can focus on either:
  - Single industry
    - Hospitals
    - Credit counseling organizations
  - A single issue common amongst a significant portion of all tax-exempt organizations:
    - Officer compensation
    - Self-certification of tax-exempt status
    - Political intervention

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Compliance Projects (cont'd.)

- Advantages of Compliance Projects
  - IRS develops an understanding of an entire industry, including practices unique to the industry.
  - The IRS may identify industry-wide issues that require additional guidance.
- Disadvantages of Compliance Projects
  - A knowledgeable IRS may result in a more thorough examination.
  - A few bad actors within an industry may taint the IRS' view of the entire industry.
  - Any published guidance may be too late.

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Phases of Compliance Projects

- Each compliance project typically follows the same order of events:
  - Phase 1: Internal review and research
  - Phase 2: Questionnaire
    - All contact is done via mail
    - Merely informational
    - Cannot lead to revocation, but can lead to an examination
  - Phase 3: Examinations
    - Very intrusive — an IRS agent will be on-site
    - Can result in revocation

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Phase 1: IRS Internal Review and Research

- The IRS will research the industry or issue that it intends to examine through the Compliance Project.
  - Form 990;
  - Media;
  - Internal discussions with various IRS divisions; and
  - Statistical information developed by economists.
- Based on the information reviewed, the IRS will develop a questionnaire and identify the organizations to obtain information from:
  - Identification of the parameters of an industry;
  - Determine appropriate sample size for project; and
  - Identify specific organizations to examine based on: size, location, information reported on the Form 990, or the organization's name.

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Phase 2: Questionnaire

- IRS will send a questionnaire to the organizations identified:
  - College and University Compliance Project: 30-page questionnaire
  - Self-Certification Compliance Project: nine-page questionnaire
- Upon receiving responses to the questionnaire, the IRS will analyze the responses to gain an understanding of industry practices and common areas of noncompliance and identify particular organizations that are noncompliant.

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Phase 2: Questionnaire (cont'd.)

- From this information, the IRS will lay the foundation for the examination phase of the compliance project by:
  - Identifying issues on which to focus examinations,
  - Developing training programs based on the issues identified, and
  - Identifying the organizations to examine.

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Phase 2: Questionnaire (cont'd.)

- Important considerations:
  - If selected as part of a compliance check project, the compliance check is not itself an IRS examination. A compliance check will not result in:
    - Revocation,
    - Assessment of taxes, or
    - A change in foundation status.
  - An organization is not legally required to complete or return a compliance check questionnaire.
  - It is strongly recommended that every organization that receives a compliance check questionnaire fully complete and return the questionnaire.

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Phase 2: Questionnaire (cont'd.)

- Who gets examined?
  - If there is extremely widespread noncompliance, the entire industry—the IRS examined approximately 80% of the credit counseling industry.
  - If noncompliance is prevalent but not extreme, then a significant portion of the industry may be examined—approximately 20% of the hospitals were examined.
  - Only 8.5% of the colleges and universities in the compliance project were examined. However, every organization that failed to complete the compliance check questionnaire was examined by the IRS.

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Phase 3: Examinations

- This phase is where the IRS will show up at your office and start asking questions and reviewing documents.
- Based on the responses to the questionnaires, the IRS will then decide the issues and organizations that will be the focus of examinations.
- Examinations will generally affect few organizations, but the impact is much greater:
  - Can take several months to several years; and
  - Can result in the assessment of additional tax or even revocation of an organization's tax-exempt status.

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The Colleges and Universities Compliance Project

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Colleges and Universities Project

Timeline

- **October 2008:** The IRS announces the Project and sends out questionnaires to over 400 tax-exempt colleges and universities.
- **May 2010:** The IRS releases an Interim Report reporting on responses to the questionnaires and announcing that it has selected 34 colleges and universities for further examination, including both public and private colleges.
- **April 2013:** On April 25, 2013, the IRS announces it has completed 90% of the examinations and releases its Final Report on the Project.

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Colleges and Universities Project

Final Report

- Discussed conclusions that were based on findings of information obtained through the compliance questionnaires and on-site examinations.
- Described common areas of noncompliance and areas of IRS enforcement during examinations, including:
  - Unrelated business income; and
  - Compensation.
- Explained the results of the examinations opened under this program.

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Unrelated Business Income

- Tax-exempt organizations are not required to pay federal income taxes on income derived from activities that are substantially related to their exempt purposes. However, a tax-exempt organization may be subject to the federal corporate income tax on income derived from unrelated trade or business activities ("UBI").
- UBI:
  - 1) The activity must be a trade or business;
  - 2) The trade or business must be regularly carried on; and
  - 3) The trade or business must not be substantially related to the purposes for which the organization was recognized as exempt from income tax.

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Unrelated Business Income (cont'd.)

- **Trade or business**: The activity must be carried on for the production of income from the sale of goods or the performance of services.
- **Regularly carried on**: The activity is conducted often and continuously. The IRS will compare the activity with the same or similar activities conducted by non-exempt organizations.
- **Substantially related**: The activity must contribute significantly to the accomplishment of one or more of the organization's exempt purposes
- **Consequences:** UBIT imposed at the regular corporate rates; may also lead to loss of exempt status.

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Examples of UBI

- UBI is a common issue for all types of exempt organizations.
- Examples:
  - Sports camps
  - Christmas cards sold by a veterans' organization
  - Museum shops— item-specific
  - Advertising in magazines and other publications

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Unrelated Business Income: Losses

- **Net Operating Losses ("NOLs")**: These are losses that are reported in one year and used to offset gains in past or future years.
- Tax law permits deductions for NOLs and for expenses that are "directly connected" with the carrying on of the unrelated trade or business.
  - For an organization to utilize losses to reduce its UBIT liability, those losses must relate to the activity or activities giving rise to UBI.

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UBI: Final Report Findings

- **90% of the schools examined misreported UBI.**
- UBI arose in connection with common categories of activities: advertising; arena use; facility rentals; and the operation of fitness and recreation centers, sports camps, and golf courses.
- The IRS determined that at least 60% of the schools' losses used to offset UBI were not sufficiently connected to unrelated business activities.
  - Over $170 million in disallowed claims of losses and NOLs against the UBIT liability of the schools examined, which could result in $60 million in taxes.
  - The IRS disallowed over $150 million in NOLs alone during the course of the examinations.

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UBI: Final Report Findings (cont'd.)

- **A Particular Focus on Losses**
  - If an activity consistently resulted in losses over the course of several years, the IRS concluded that such activities lacked the necessary "profit motive" that characterizes a trade or business.
  - The IRS identified numerous instances in which examined colleges and universities had reported net losses on activities "for which expenses had consistently exceeded UBI for many years."
  - Other issues included errors in computation of NOLs and the substantiation of such amounts and misclassification of activities as related to the institution's exempt purposes.

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Compensation

- **Issues related to compensation can result in two types of IRS enforcement:**
  - Enforcement against the organization that provides the compensation, which could result in the revocation of the organization's tax-exempt status stemming from:
    - The provision of an impermissible private benefit; or
    - The inurement of an organization's assets to certain individuals.
  - Enforcement against the individuals who receive excessive compensation through the provision of excise taxes on such individuals.

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Private Benefit and Private Inurement

- **Private Benefit**: Generally, organizations exempt under Section 501(c) must be organized and operated for the benefit of the public, rather than for private, interests.
  - Quantitative test
  - Qualitative test
- **Private Inurement**: Charitable organizations are also prohibited from allowing any part of their net earnings to inure to the benefit of any private individual or shareholder.
  - Only applicable to transactions between a tax-exempt organization and an "insider"

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Intermediate Sanctions

- IRC Section 4958 allows the IRS to impose excise taxes on "disqualified persons" who receive "excess benefits."
- An "excess benefit" is any benefit that exceeds the FMV of the consideration received, including:
  - Compensation that exceeds FMV;
  - The purchase of an asset for an amount that exceeds the FMV of the asset; and
  - The sale of an asset for substantially less than FMV.

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Intermediate Sanctions

- Disqualified persons include:
  - ODTKEs— officers, directors, trustees, and key employees.
  - Others in a position to influence an organization.
- Penalties
  - Individual recipient must return the excessive portion of the benefit to the organization, and 25% excise tax on the excessive value of the benefit.
  - Excise tax of up to 200% (of the excess benefit amount) on the individual recipient.
  - Excise tax of 10% on every ODTKE that approved the transaction.
- Revocation of exempt status is also a potential consequence.

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Rebuttable Presumption

- Section 4958 and the accompanying Treasury Regulations provide a "safe harbor" that results in a rebuttable presumption that amounts paid by the organization to its ODTKEs are reasonable.
- To establish the rebuttable presumption, before paying any amount under the transaction:
  - The organization must appoint an "independent body" to review and determine the amount of compensation;
  - The independent body must rely on appropriate comparability data to set the compensation amount from comparable organizations; and
  - The independent body must contemporaneously document its decisions in setting compensation.

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Compensation

Final Report Findings

- Compensation of ODTKEs at **94% of schools** examined was set following procedures intended to satisfy the requirements for the rebuttable presumption.
- **50% of schools** used compensation consultants.
- However, the IRS concluded that **20% of the institutions** examined did **not** satisfy the standards established by the Treasury Regulations.
  - Comparability data derived, at least in part, from organizations that were not “similarly situated.”
  - Compensation studies did not document how and/or why certain data was used or did not specify whether the amounts reported included salary only or also included benefits.

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Compensation

Final Report Findings (cont’d.)

- **Non-ODTKE Compensation:** Heads of departments, faculty, coaches, and administrative and managerial employees were among other highly compensated non-ODTKEs at the schools examined.
- Non-ODTKEs generally do not fall within the categories of individuals that are per se treated as “disqualified persons” for purposes of the intermediate sanctions rules but may ultimately be deemed a “disqualified person” based on facts and circumstances.
  - May also be deemed to have received a prohibited private benefit.

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Lessons to Be Learned from the Final Report

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Lessons for Tax-Exempt Colleges and Universities

- **This report provides:**
  - Information on common areas of noncompliance within colleges and universities;
  - Insight into areas of IRS focus during future examinations of colleges and universities and other exempt organizations; and
  - A very specific guide for college and university compliance with all requirements for tax-exempt status.

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Lessons for All Tax-Exempt Organizations

- **Complete IRS Questionnaires:** If an organization receives a compliance check questionnaire as part of an IRS initiative, the organization should complete it and file it with the IRS.
  - In this Project, 13 colleges and universities received, but did not complete, the questionnaire, and the IRS opened examinations of all 13 schools.

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Lessons for All Tax-Exempt Organizations (cont'd.)

- **Prepare for UBI and Executive Compensation to Be a Focus:** During the course of the Project, the IRS went to great lengths to educate its revenue agents about these issues and their consequences.
  - In testimony before the House Ways and Means Committee in May 2013, EO Director Lois Lerner stated that the IRS is currently planning a more expansive project, to begin in 2014, which will investigate whether issues identified in the Final Report are present across a greater portion of the tax-exempt sector.

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Lessons for All Tax-Exempt Organizations (cont'd.)

- **Review Methods and Policies for Compensation:** Organizations exempt under Sections 501(c)(3) or 501(c)(4) should closely review their methods for setting executive compensation and their use of comparability data.
  - Having a formal compensation policy can assist an organization in establishing the rebuttable presumption of reasonable compensation.
- **Review Procedures for Selecting Comparability Data:** Organizations that do not use compensation consultants should review their own procedures for selecting comparability data to ensure that such data reflects the practices of similarly situated entities, particularly the types of surveys used.

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Lessons for All Tax-Exempt Organizations (cont'd.)

- **Seek and Use Outside Advice:** When completing tax forms and determining an organization's UBIT liability, organizations should allow adequate time to consult with their tax counsel in order to ensure that expenses are accurately allocated, and that losses and NOLs bear the requisite relationship to the activity.
- When using an **outside consultant** for compensation data, organizations should **ask questions** about the origins of the data and ascertain whether the data reflects the practices of organizations that are truly similarly situated.

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Lessons for All Tax-Exempt Organizations (cont'd.)

- **Consider Trade Associations:** Smaller organizations may not be able to hire outside experts to assist with UBI and executive compensation issues, but they can receive substantial benefits from membership in a trade association of similar entities that can pool their resources and, collectively, hire appropriate experts.
- **Consider Subsidiaries:** If a tax-exempt organization is contemplating substantial engagement in an unrelated business activity, a taxable, wholly owned subsidiary may be a helpful option to house the activity and protect the organization's tax-exempt status.

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Questions?

Jeffrey S. Tenenbaum, Esq.
JSTenenbaum@Venable.com
t 202.344.8138

Matthew T. Journy, Esq.
mtjourny@Venable.com
t 202.344.4589

Margaret C. Rohlfing, Esq.
mcrohlfing@Venable.com
t 202.344.4297

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Speaker Biographies

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our people

Jeffrey S. Tenenbaum

Partner

Washington, DC Office

T 202.344.8138 F 202.344.8300

jstenenbaum@Venable.com

Jeffrey Tenenbaum chairs Venable's Nonprofit Organizations Practice Group. He is one of the nation's leading nonprofit attorneys, and also is an accomplished author, lecturer, and commentator on nonprofit legal matters. Based in the firm's Washington, DC office, Mr. Tenenbaum counsels his clients on the broad array of legal issues affecting charities, foundations, trade and professional associations, think tanks, advocacy groups, and other nonprofit organizations, and regularly represents clients before Congress, federal and state regulatory agencies, and in connection with governmental investigations, enforcement actions, litigation, and in dealing with the media. He also has served as an expert witness in several court cases on nonprofit legal issues.

Mr. Tenenbaum was the 2006 recipient of the American Bar Association's Outstanding Nonprofit Lawyer of the Year Award, and was an inaugural (2004) recipient of the *Washington Business Journal*'s Top Washington Lawyers Award. He was one of only seven "Leading Lawyers" in the Not-for-Profit category in the prestigious 2012 *Legal 500* rankings, and one of only eight in the 2013 rankings. Mr. Tenenbaum was recognized in 2013 as a Top Rated Lawyer in Tax Law by *The American Lawyer* and *Corporate Counsel*. He was the 2004 recipient of The Center for Association Leadership's Chairman's Award, and the 1997 recipient of the Greater Washington Society of Association Executives' Chairman's Award. Mr. Tenenbaum was listed in the 2012-14 editions of *The Best Lawyers in America* for Non-Profit/Charities Law, and was named as one of Washington, DC's “Legal Elite” in 2011 by *SmartCEO Magazine*. He was a 2008-09 Fellow of the Bar Association of the District of Columbia and is AV Peer-Review Rated by *Martindale-Hubbell*. Mr. Tenenbaum started his career in the nonprofit community by serving as Legal Section manager at the American Society of Association Executives, following several years working on Capitol Hill as a legislative assistant.

AREAS OF PRACTICE

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INDUSTRIES

Nonprofit Organizations and Associations

Credit Counseling and Debt Services

Financial Services

Consumer Financial Protection Bureau Task Force

GOVERNMENT EXPERIENCE

Legislative Assistant, United States House of Representatives

BAR ADMISSIONS

District of Columbia

REPRESENTATIVE CLIENTS

AARP
American Academy of Physician Assistants
American Alliance of Museums
American Association for the Advancement of Science
American Bar Association
American Bureau of Shipping
American Cancer Society
American College of Radiology
American Institute of Architects
Air Conditioning Contractors of America
American Society for Microbiology
American Society for Training and Development
American Society of Anesthesiologists
American Society of Association Executives

EDUCATION

J.D., Catholic University of America, Columbus School of Law, 1996

B.A., Political Science, University of Pennsylvania, 1990

MEMBERSHIPS

American Society of Association Executives

California Society of Association Executives

New York Society of Association Executives

Association for Healthcare Philanthropy
Association of Corporate Counsel
Association of Private Sector Colleges and Universities
Automotive Aftermarket Industry Association
Brookings Institution
Carbon War Room
The College Board
Council on Foundations
CropLife America
Cruise Lines International Association
Design-Build Institute of America
Foundation for the Malcolm Baldrige National Quality Award
Gerontological Society of America
Goodwill Industries International
Homeownership Preservation Foundation
Human Rights Campaign
The Humane Society of the United States
Independent Insurance Agents and Brokers of America
Institute of International Education
International Association of Fire Chiefs
Jazz at Lincoln Center
LeadingAge
Lincoln Center for the Performing Arts
Lions Club International
Money Management International
National Association of Chain Drug Stores
National Association of College and University Attorneys
National Association of Music Merchants
National Athletic Trainers' Association
National Board of Medical Examiners
National Coalition for Cancer Survivorship
National Defense Industrial Association
National Fallen Firefighters Foundation
National Fish and Wildlife Foundation
National Hot Rod Association
National Propane Gas Association
National Quality Forum
National Retail Federation
National Student Clearinghouse
The Nature Conservancy
NeighborWorks America
Peterson Institute for International Economics
Professional Liability Underwriting Society
Project Management Institute
Public Health Accreditation Board
Public Relations Society of America
Recording Industry Association of America
Romance Writers of America
Trust for Architectural Easements
United Nations High Commissioner for Refugees
Volunteers of America

HONORS

Recognized as "Leading Lawyer" in the 2012 and 2013 editions of *Legal 500*, Not-For-Profit

Listed in *The Best Lawyers in America* for Non-Profit/Charities Law, Washington, DC (Woodward/White, Inc.), 2012-14

Recognized as a Top Rated Lawyer in Taxation Law in *The American Lawyer* and *Corporate Counsel*, 2013

Washington DC's Legal Elite, *SmartCEO Magazine*, 2011

Fellow, Bar Association of the District of Columbia, 2008-09

Recipient, American Bar Association Outstanding Nonprofit Lawyer of the Year

Award, 2006

Recipient, *Washington Business Journal* Top Washington Lawyers Award, 2004

Recipient, The Center for Association Leadership Chairman's Award, 2004

Recipient, Greater Washington Society of Association Executives Chairman's Award, 1997

Legal Section Manager / Government Affairs Issues Analyst, American Society of Association Executives, 1993-95

AV® Peer-Review Rated by *Martindale-Hubbell*

Listed in *Who's Who in American Law* and *Who's Who in America*, 2005-present editions

ACTIVITIES

Mr. Tenenbaum is an active participant in the nonprofit community who currently serves on the Editorial Advisory Board of the American Society of Association Executives' *Association Law & Policy* legal journal, the Advisory Panel of Wiley/Jossey-Bass' *Nonprofit Business Advisor* newsletter, and the ASAE Public Policy Committee. He previously served as Chairman of the *AL&P* Editorial Advisory Board and has served on the ASAE Legal Section Council, the ASAE Association Management Company Accreditation Commission, the GWSAE Foundation Board of Trustees, the GWSAE Government and Public Affairs Advisory Council, the Federal City Club Foundation Board of Directors, and the Editorial Advisory Board of Aspen's *Nonprofit Tax & Financial Strategies* newsletter.

PUBLICATIONS

Mr. Tenenbaum is the author of the book, *Association Tax Compliance Guide*, now in its second edition, published by the American Society of Association Executives. He also is a contributor to numerous ASAE books, including *Professional Practices in Association Management*, *Association Law Compendium*, *The Power of Partnership*, *Essentials of the Profession Learning System*, *Generating and Managing Nondues Revenue in Associations*, and several Information Background Kits. In addition, he is a contributor to *Exposed: A Legal Field Guide for Nonprofit Executives*, published by the Nonprofit Risk Management Center. Mr. Tenenbaum is a frequent author on nonprofit legal topics, having written or co-written more than 500 articles.

SPEAKING ENGAGEMENTS

Mr. Tenenbaum is a frequent lecturer on nonprofit legal topics, having delivered over 500 speaking presentations. He served on the faculty of the ASAE Virtual Law School, and is a regular commentator on nonprofit legal issues for *The New York Times*, *The Wall Street Journal*, *The Washington Post*, *Los Angeles Times*, *The Washington Times*, *The Baltimore Sun*, *ESPN.com*, *Washington Business Journal*, *Legal Times*, *Association Trends*, *CEO Update*, *Forbes Magazine, The Chronicle of Philanthropy, The NonProfit Times* and other periodicals. He also has been interviewed on nonprofit legal topics on Fox 5 television's (Washington, DC) morning news program, Voice of America Business Radio, Nonprofit Spark Radio, and The Inner Loop Radio.

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our people

Matthew T. Journy

Associate

Washington, DC Office

T 202.344.4589 F 202.344.8300

mtjourny@Venable.com

AREAS OF PRACTICE

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GOVERNMENT EXPERIENCE

Attorney, Internal Revenue Service

BAR ADMISSIONS

Massachusetts

District of Columbia

EDUCATION

LL.M., Georgetown University Law Center, 2006

J.D., Northeastern University School of Law, 2003

B.A., Marquette University, 1999

Matt Journy is an associate in Venable's Washington, DC office, where he practices in the Nonprofit Organizations and Associations Practice Group. In his practice, Mr. Journy counsels trade and professional associations, public charities, private foundations, and other nonprofits on a variety of tax, governance, and general corporate matters, including tax exemption applications, audits, tax planning, joint ventures, unrelated business income tax issues, lobbying, and charitable solicitation, among other issues.

Mr. Journy also represents nonprofit clients in tax disputes with the IRS. Mr. Journy has represented clients before the IRS during each stage of the IRS examination process, including: the examination stage and administrative appeals process. If the tax controversy is not resolved administratively, Mr. Journy represents the client in court litigation, typically in U.S. Tax Court.

SIGNIFICANT TAX CONTROVERSY LITIGATION MATTERS

- Successful representation in U.S. Tax Court of taxpayer accused by IRS of having entered into an “excess benefit” transaction under IRC § 4958. After developing a thorough factual record and expert testimony demonstrating that the transaction between the taxpayer and the tax-exempt organization provided a substantial benefit to the nonprofit entity and thus, did not constitute an “excess benefit” transaction, the IRS conceded the case, acknowledging that taxpayer owed no additional tax.
- Litigated multiple Declaratory Judgment matters contesting the authority of the IRS to issue a final adverse determination letter to organizations recognized as exempt under IRC § 501(c)(3). Settling each case by entering into a closing agreement under which the IRS continued to recognize the organization’s tax-exempt status.
- Litigated and negotiated favorable settlement of deficiency cases resulting from the revocation of a nonprofit organization’s tax-exempt status.

Mr. Journy has appeared frequently before the IRS National Office, representing clients in requests for private letter rulings or technical advice memoranda.

Having worked both as a regulator and tax consultant in the nonprofit community, Mr. Journy draws upon his prior experience to provide clients with reliable and thorough advice on the wide array of legal issues faced by nonprofits. Before joining Venable, Mr. Journy worked at Ernst & Young, LLP in the National Tax Practice, where he provided nonprofit clients with tax advice relating to corporate reorganizations, expenditure responsibility for international grants, fundraising activities, commercial co-ventures, unrelated business income, and post-issuance compliance for private activity bonds. In addition to providing tax advice, Mr. Journy provided tax compliance services, including the technical review of various federal and state tax and information returns. Prior to joining Ernst & Young, Mr. Journy worked in the Tax-Exempt/Government Entities Division of the IRS Office of Chief Counsel, where he prepared legal and technical advice for field agents and composed legal memoranda

on a variety of issues affecting tax-exempt organizations.

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Recognized in the 2013 edition of *Legal 500*, Not-For-Profit

PUBLICATIONS

- September 26, 2013, Nonprofit Executive Summit: Bringing Nonprofit Leaders Together to Discuss Legal, Finance, Tax, and Operational Issues Impacting the Sector
- September 2013, Tools for Bypassing IRS Delays in EO Applications
- July 2013, Lessons from the IRS Nonprofit College and University Compliance Project: Final Report Offers a Wealth of Information for All Tax-Exempt Organizations (article – long version)
- July 9, 2013, A Look at the IRS Final Report on the Nonprofit Colleges and Universities Compliance Project: UBIT and Executive Compensation Lessons for All Tax-Exempt Organizations (presentation)
- May 2013, IRS Releases Final Report on Nonprofit Colleges and Universities Compliance Project: UBIT and Executive Compensation Lessons for All Tax-Exempt Organizations (article – short version)
- April 18, 2013, An Unfair Fight: IRS Enforcement of Intermediate Sanctions and the Lessons Learned from Recent Tax Controversies
- March 12, 2013, Protecting Your Nonprofit Housing Counseling Agency's 501(c)(3) Status
- March 2013, IRS Denials of Tax-Exempt Status to Mortgage Foreclosure Assistance Providers Offer Lessons for Housing Counseling Agencies
- March/April 2013, Using Section 7428 to Resolve Exempt Status Controversies, *Taxation of Exempts, Volume 24, Number 5*
- February 5, 2013, IRS Releases Exempt Organizations 2012 Annual Report and 2013 Workplan
- February 4, 2013, IRS Examinations of Nonprofit Housing Counseling Agencies
- January 28, 2013, Protecting Tax-Exempt Status: The Importance of Intangible Asset Valuation
- October 11, 2012, Nonprofit Executive Compensation and Incentive Compensation: Keys to Protecting Your Organization and Its Leaders from IRS Sanctions
- September 28, 2012, Paying for the Best: Executive Compensation for Section 501(c)(3) Public Charities (White Paper)
- July 10, 2012, The Next Generation of Nonprofit Executive Compensation: The Keys to Withstanding IRS Scrutiny
- June 19, 2012, The Next Generation of Nonprofit Executive Compensation: The Keys to Withstanding IRS Scrutiny
- May 15, 2012, IRS to Focus on Housing Counseling Agencies
- March 20, 2012, All About UBIT: What Nonprofit Leaders Need to Know
- January 26, 2012, The Next Generation of Nonprofit Executive Compensation: Providing a Competitive Advantage for Your Organization
- October 24, 2011, Unrelated Business Income Tax for Nonprofits: The Basics
- August 23, 2011, Nonprofit Executive Compensation: Avoiding the Treacherous Tax and Governance Pitfalls
- June 29, 2011, Nonprofit Salary Trends and Executive Compensation Issues
- June 16, 2011, Sponsorships, Advertising, Endorsements and Cause Marketing: Understanding Critical UBIT Issues for Nonprofits
- June 13, 2011, IRS Nonprofit College & University Compliance Project: Findings, Examinations and Mock Audits
- May 13, 2011, IRS Denies 501(c)(3) Status to Bankruptcy Counseling Agency
- April 12, 2011, Internal Revenue Code Section 501(q) and Its Critical Implications for the Nonprofit Housing Counseling Industry in Light of Recent IRS Guidance

SPEAKING ENGAGEMENTS

- December 4, 2013, "How to Protect Your Tax-Exempt Status – Beyond the Basics" at the NYSSCPA and FAE Exempt Organizations Conference
- October 24, 2013, The IRS Final Report on Nonprofit Colleges and Universities: Lessons for All Tax-Exempt Organizations
- September 26, 2013, Nonprofit Executive Summit: Bringing Nonprofit Leaders Together to Discuss Legal, Finance, Tax, and Operational Issues Impacting the Sector
- July 25, 2013, "The IRS College and University Compliance Project Final Report: UBIT & Executive Compensation Lessons for All Tax-Exempt Organizations" for Non-Profit Cooperation Circle
- July 9, 2013, Legal Quick Hit: "A Look at the IRS Final Report on the Nonprofit Colleges and Universities Compliance Project: UBIT and Executive Compensation Lessons for All Tax-Exempt Organizations" for the Association of Corporate Counsel's Nonprofit Organizations Committee
- April 18, 2013, "An Unfair Fight: IRS Enforcement of Intermediate Sanctions and the Lessons Learned from Recent Tax Controversies" at the 1st Annual Institute on Not-for-Profit Law
- March 12, 2013, Protecting Your Nonprofit Housing Counseling Agency's 501(c)(3) Status
- January 28, 2013, "Protecting Tax-Exempt Status: The Importance of Intangible Asset Valuation," for the New York State Society of CPAs
- December 12, 2012, Association of Corporate Counsel Webcast: "Nonprofit Executive Compensation and Incentive Compensation: Keys to Protecting Your Organization and Its Leaders from IRS Sanctions"
- October 11, 2012, "Nonprofit Executive Compensation and Incentive Compensation: Keys to Protecting Your Organization and Its Leaders from IRS Sanctions" for Guidestar
- July 10, 2012, Legal Quick Hit: "The Next Generation of Nonprofit Executive Compensation: The Keys to Withstanding IRS Scrutiny" for the Association of Corporate Counsel's Nonprofit Organizations Committee
- June 19, 2012, "The Next Generation of Nonprofit Executive Compensation: The Keys to Withstanding IRS Scrutiny" for GuideStar
- March 20, 2012, "All About UBIT: What Nonprofit Leaders Need to Know" for the Better Business Bureau of New York
- January 26, 2012, The Next Generation of Nonprofit Executive Compensation: Providing a Competitive Advantage for Your Organization
- November 3, 2011, National Business Officers Association / National Association of College and University Business Officers Tax Forum on School, College and University Nonprofit Tax Challenges
- August 23, 2011, Nonprofit Executive Compensation: Avoiding the Treacherous Tax and Governance Pitfalls
- June 29, 2011, "Nonprofit Executive Compensation" for Association TRENDS
- June 16, 2011, Sponsorships, Advertising, Endorsements and Cause Marketing: Understanding Critical UBIT Issues for Nonprofits
- June 13, 2011, "Internal Revenue Service (IRS) Compliance Project: Findings and Examinations; 990 Discussions," 9th Annual Higher Education Compliance Conference
- April 12, 2011, Internal Revenue Code Section 501(q) and Its Critical Implications for the Nonprofit Housing Counseling Industry in Light of Recent IRS Guidance
- April 10, 2011, "Top Tax Issues Relating to Income Generated by State and Municipal Organizations Exempt under Sections 115, 501(c)(3) and 501(c)(4)" at the 2011 IMLA Mid-Year Seminar
- March 8, 2011, Legal Quick Hit: "Sponsorships, Advertising, Endorsements, and Cause Marketing - Understanding Critical UBIT Issues for Nonprofits" for the Association of Corporate Counsel's Nonprofit Organizations Committee

VENABLE® LLP

our people

Margaret C. Rohlfing

Associate

Washington, DC Office

T 202.344.4297 F 202.344.8300

mcrohlfing@Venable.com

Margaret Rohlfing is an associate in Venable's Regulatory Practice Group, where she focuses on transactional, regulatory and policy matters in several industries. Ms. Rohlfing assists clients with ongoing regulatory compliance matters before federal and state agencies and commissions.

While earning her law degree, Ms. Rohlfing completed an internship at the Federal Election Commission (FEC) and served as a judicial intern in the chambers of the Honorable Edward J. Damich of the United States Court of Federal Claims.

PUBLICATIONS

- August 21, 2013, Will FEC Complaint Dismissal Bring More Donor Secrecy?, *Law360*
- July 2013, Lessons from the IRS Nonprofit College and University Compliance Project: Final Report Offers a Wealth of Information for All Tax-Exempt Organizations (article – long version)
- July 9, 2013, A Look at the IRS Final Report on the Nonprofit Colleges and Universities Compliance Project: UBIT and Executive Compensation Lessons for All Tax-Exempt Organizations (presentation)
- May 2013, IRS Releases Final Report on Nonprofit Colleges and Universities Compliance Project: UBIT and Executive Compensation Lessons for All Tax-Exempt Organizations (article – short version)
- February 5, 2013, IRS Releases Exempt Organizations 2012 Annual Report and 2013 Workplan
- November 26, 2012, Government Contractors Face Growing Risks from Laws Regulating Political Contributions, Political Law Alert
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- October 2012, IRS Releases Group Exemption Questionnaire as Part of Compliance Check Initiative, *Nonprofit Alert*

SPEAKING ENGAGEMENTS

- October 24, 2013, The IRS Final Report on Nonprofit Colleges and Universities: Lessons for All Tax-Exempt Organizations
- July 25, 2013, "The IRS College and University Compliance Project Final Report: UBIT & Executive Compensation Lessons for All Tax-Exempt Organizations" for Non-Profit Cooperation Circle
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AREAS OF PRACTICE

Regulatory

INDUSTRIES

Nonprofit Organizations and Associations

BAR ADMISSIONS

District of Columbia

Virginia

EDUCATION

J.D., University of Virginia School of Law, 2012

- Order of the Coif
- Dillard Fellow of Legal Research and Writing
- Editorial Board, *The Journal of Law and Politics*

A.B., *summa cum laude*, Duke University, 2009

- Phi Beta Kappa

Additional Information

VENABLE LLP

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AUTHORS:

Margaret C. Rohlfing*
mcrohlfing@Venable.com
202.344.4297

Matthew T. Journy
mtjourny@Venable.com
202.344.4589

Yosef Ziffer
yziffer@Venable.com
410.244.7550

Jeffrey S. Tenenbaum
jstenenbaum@Venable.com
202.344.8138

*DC Bar Admission Pending

Lessons from the IRS Nonprofit College and University Compliance Project: Final Report Offers a Wealth of Information for All Tax-Exempt Organizations

In October 2008, the Internal Revenue Service ("IRS") began work on the nonprofit Colleges and Universities Compliance Project (the "Project"), distributing an initial compliance questionnaire to over 400 tax-exempt colleges and universities. Based on the information obtained from the compliance questionnaires, the IRS then selected 34 colleges and universities for further examination.

The schools selected for examination included both public and private colleges and universities, with about two-thirds of those examined considered large schools (i.e., over 15,000 students). The IRS has now completed 90% of those examinations, and, on April 25, 2013, the IRS released its final report on the Project (the "Final Report").[1] The Final Report summarizes the findings from the completed examinations and represents the culmination of almost five years of research and analysis of the tax-exempt higher education community.

Although the Project focused on colleges and universities only, the Final Report nevertheless contains critical information that can be used by all tax-exempt organizations. Specifically, the Report can help organizations identify and understand issues that will be the likely focus of future examinations, such as unrelated business income and executive compensation. The IRS is likely to remain particularly vigilant in reviewing and overseeing compliance with the rules applicable to these two areas in future examinations of all organizations recognized as exempt under Internal Revenue Code Section 501(c)(3).

The role and nature of IRS compliance projects

The use of compliance check projects is an emerging trend at the IRS, and all exempt organizations should be aware of the steps and processes involved in such initiatives. Over the last decade, the IRS has conducted three detailed compliance projects, including reviews of tax-exempt hospitals and tax-exempt credit counseling organizations. It is currently engaged in two more: one project is focused on the exempt housing counseling and foreclosure prevention industry and the other on organizations that use the self-certification process. In the past, the IRS relied primarily on individual examinations to identify areas of misreporting or noncompliance. Now, the development of compliance check projects allows the IRS to gain information about a broader portion of an industry and develop more focused examinations accordingly.

In a compliance project, the IRS broadly reviews an entire industry at one time, comparing organizations within the industry to gain an understanding of common practices, such as reporting of income and classification of common activities. By taking a snapshot of an entire industry, the IRS can identify anomalies that may indicate broader trends within the industry. These compliance projects then help the IRS identify common areas of potential abuse and noncompliance on which agents can focus in future examinations.

Each compliance project typically follows the same order of events, beginning with the creation and distribution of a compliance check questionnaire and ultimately leading to on-site examinations by IRS agents. There are several phases to each project. After identifying an industry, the IRS prepares and sends out a compliance check questionnaire to a significant portion of that chosen industry. The compliance check questionnaire is the phase that touches the broadest segment of the identified industry. The colleges and universities that received the Project's initial questionnaire represent about 16% of the entire tax-exempt higher education field.

The questionnaires are typically designed to collect a substantial amount of information about the practices of organizations in the sector. In the Project, the questionnaire developed by the IRS was over 30 pages long and asked for substantial information about the institution's income, compensation of various employees including athletic coaches and faculty, related exempt organizations, the types of unrelated business activities in which the institution engaged, accounting methods, endowment funds, and governance policies, among other categories.[2]

The IRS uses the responses to the questionnaires, coupled with data from the Forms 990 and 990-T filed by the organizations that received the questionnaire, to learn about the operations of these institutions. The initial analysis of the Project data identified unrelated business income and executive compensation as areas of common noncompliance. The IRS then selected 34 schools for examination based specifically on those two categories of potential noncompliance.

The next phase, on-site examinations, affects a much smaller segment of an industry but is the most burdensome, time-consuming, and potentially problematic for an organization. Unlike the review of a compliance check questionnaire, an examination can result in the assessment of additional tax or even revocation of an organization's tax-exempt status. The number of examinations the IRS typically opens during a compliance project depends on the information that the IRS obtains from its review of the questionnaires. In the Project, about 8.5% of the total number of colleges and universities that originally received the questionnaire were ultimately selected for examination. By way of comparison, during the hospital compliance project that began in 2006, the IRS opened up examinations at 20 tax-exempt hospitals. During the credit counseling compliance project that took place between 2004 and 2012, the IRS conducted examinations of more than 80% of the industry, as measured by revenue.

Final Report findings

As noted above, in the Final Report, the IRS identified certain trends and potential areas of widespread noncompliance with respect to reporting unrelated business taxable income and the payment of compensation, both to officers and to other highly compensated employees.

Unrelated business income

Tax-exempt organizations generally are not required to pay federal income taxes on income derived from activities that are substantially related to their exempt purposes. A tax-exempt organization may, however, be subject to the federal corporate income tax on income derived from unrelated trade or business activities. This tax is known as the unrelated business income tax ("UBIT").

Unrelated business income ("UBI") arises when a tax-exempt organization regularly carries on a trade or business that is not substantially related to the tax-exempt purposes of the organization. The Code imposes UBIT at the regular corporate rates on an organization's UBI, reduced by the organization's related losses and deductions. The regulations explain the rationale for the UBIT regime with the following background: "The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete."[3]

An "unrelated trade or business" is any activity that meets each of the following three conditions:

- The activity must be a trade or business.

- The trade or business must be regularly carried on.
- The trade or business must not be substantially related to the purposes for which the organization was recognized as exempt from income tax.[4]

To be a "trade or business" the activity must be carried on for the production of income from the sale of goods or the performance of services.[5] It is important to recognize that activities do not lose their identity as a trade or business simply because they might be conducted as part of similar activities related to the organization's exempt purpose. For example, in the colleges and universities context, operating a golf course that is used to provide educational benefits to students does not mean that income from the use of the golf course by non-student members of the general public for recreation also does not constitute a trade or business.

In determining whether an activity is "regularly carried on," the IRS will look at whether the activity is conducted often and continuously and how it is pursued. The IRS will compare the activity with the same or similar activities conducted by non-exempt organizations. Finally, for the activity to be "substantially related" to an organization's exempt purposes, it must contribute significantly to the accomplishment of one or more of the organization's exempt purposes. Merely generating money for use in pursuit of an organization's exempt purposes, however, is not itself enough to characterize an activity as "substantially related."[6]

Misunderstanding UBI and unrelated business activities can have severe consequences for an organization. Outside of paying tax on income generated from the activity, a tax-exempt organization can jeopardize its exempt status if an unrelated business activity is substantial in relation to an organization's total exempt functions. This is why organizations that engage in one or more unrelated business activities in a more than insubstantial manner often create taxable for-profit subsidiaries to house and carry out such activities.

Among the colleges and universities examined, the IRS found that adjustments to UBIT liability often arose in connection with certain activities that were regularly carried on and were not substantially related to the exempt purposes of the institutions. These activities included advertising, arena use, facility rentals, and the operation of fitness and recreation centers, sports camps, and golf courses. Nearly half of the colleges and universities examined incurred changes to their UBIT liability in connection with their advertising and facility rentals. Similarly, the operation of fitness, recreation, sports, and golf programs resulted in UBIT adjustments for approximately one-third of the organizations examined.[7]

The Final Report also contains important findings about reporting of UBI. When an organization generates at least $1,000 of gross UBI, it must file a Form 990-T, "Exempt Organization Business Income Tax Return," to report the income and pay any taxes due on that income. The Form 990-T must be filed in conjunction with the organization's annual Form 990. When computing and reporting UBI, an organization can take a number of tax deductions. The Code permits deductions for net operating losses (NOLs),[8] and organizations may also take deductions for expenses that are "directly connected" with the carrying on of the unrelated trade or business.[9] Thus, for an organization to utilize losses to reduce its UBIT liability, those losses must relate to the activity or activities giving rise to UBI. Conversely, if the losses do not arise from the conduct of an unrelated trade or business, they may not be used to offset UBI.

The Final Report notes that 90% of the schools examined had misreported UBI on their Forms 990 and 990-T during the years under examination. The scope of these reporting discrepancies includes over $170 million in disallowed claims of losses and NOLs against the UBIT liability of these institutions. The resulting changes in the reporting of losses and NOLs could result in over $60 million in assessed taxes. On 60% of the Forms 990-T that it examined, the IRS determined that losses used to offset UBI were not sufficiently connected to unrelated business activities. The Final Report also notes that the IRS disallowed more than $150 million in NOLs during the course of its Project-related examinations, because the examining agents found that the institutions failed to demonstrate the requisite connection between the trades or business and the activities generating losses.[10]

In particular, if an activity consistently resulted in losses over the course of several years, the IRS concluded that such activities lacked the necessary "profit motive" that characterizes a trade or business.[11] As such, the IRS did not allow those losses to reduce an organization's UBIT exposure. The IRS identified numerous instances in which examined colleges and universities had reported net losses on activities "for which expenses had consistently exceeded UBI for many years." The IRS determined that these activities were not carried on with a profit motive and, as such, disallowed the NOLs that flowed from those activities.[12]

Other common findings among the examined colleges and universities included errors in computation of NOLs and the substantiation of such amounts and misclassification of activities as related to the institution's tax-exempt

purposes. About 40% of the institutions examined had misclassified activities as exempt and not reportable, leading to the reclassification of nearly $4 million as UBI, subject to tax. In conducting the examinations, the IRS found that activities classified as exempt were not in fact substantially related to the organization's exempt purposes.[13]

The IRS found that only 20% of the institutions examined sought outside advice about potentially unrelated business activities and UBI reporting.[14] With the complexity of UBI and reporting issues, outside advice is critically important. In the event of an examination, the IRS may not ultimately agree with decisions about characterization of an activity or how income was reported, as was the case in several of the Project-related examinations, but obtaining legal and accounting advice and documenting the organization's decisions can help the organization defend its position during an IRS examination.

Executive compensation

Organizations exempt under Section 501(c)(3) must be organized and operated for the benefit of the public, rather than for private interests.[15] To the extent an organization confers a substantial benefit on any private individual or entity, the IRS can find that the organization is not operating exclusively for exempt purposes. However, "[o]ccasional economic benefits flowing to persons as an incidental consequence of an organization pursuing exempt charitable purposes will not generally constitute prohibited private benefits."[16] Thus, the IRS and courts have recognized that private persons will necessarily benefit, under some circumstances, when an exempt organization carries out its mission.

Determining whether such benefits constitute impermissible private benefits to individuals focuses on whether the benefits are incidental, qualitatively and quantitatively, to the public benefits the organization furnishes. For the qualitative aspect of the test, the IRS focuses on whether the benefit to the public of the organization's activities cannot be achieved without a benefit to certain private individuals, and ensuring that the private benefit is no larger than necessary to carry out the public benefit.[17] On the quantitative side, a benefit will be considered quantitatively insignificant if it is insubstantial when compared with the public benefit the organization confers. The amount of private benefit, therefore, varies with the public benefit in this comparative test.[18]

As part of this prohibition on private benefit, charitable organizations are also prohibited from allowing any part of their net earnings to inure to the benefit of any private individual or shareholder. A "private individual or shareholder" refers to a person having a personal and private interest in the activities of the organization.[19] This concept, known as "private inurement," is commonly viewed as a part of the private benefit analysis. Private inurement is more limited, however, in that the prohibition focuses on the beneficiaries' relationship to the organization and the types of benefits being received. As such, "all inurement is private benefit, but not all private benefit is inurement."[20] The private inurement doctrine applies only to transactions between a tax-exempt organization and an "insider" (i.e., someone with a close relationship with or ability to exert influence over the organization). It is important to note that this doctrine does not prohibit dealings between a charity and its insiders; it requires that dealings between a charitable organization and its insiders be reasonable, at arm's length, and in good faith. For example, paying reasonable compensation to a founder for services rendered is not considered private inurement.[21]

In lieu of, or in addition to, the possibility of revocation of exempt status if an organization's net earnings inure to the benefit of an insider, Internal Revenue Code Section 4958 allows the IRS to impose excise taxes on "disqualified persons" who receive "excess benefits" from a transaction with an exempt organization. Taxes assessed on excess benefit transactions under Section 4958 are known as "intermediate sanctions." These penalty taxes apply only if an organization pays an amount in excess of what would reasonably be paid by a similarly situated organization for comparable services. If a Section 501(c)(3) organization pays reasonable compensation to its officers, directors, trustees, and key employees ("ODTKEs"), no excess benefit transaction occurs.

Through the intermediate sanctions provisions of the Code, the IRS may require an individual who is deemed to have received unreasonable compensation to return the excessive portion of the compensation to the organization. It may also impose an excise tax of up to 200% (of the excess benefit amount) on the individual who received the excessive benefit. Additionally, the IRS may impose an excise tax of 10% on every ODTKE that approved the transaction. Finally, as conferring an excess benefit will likely cause an organization's assets to inure to the benefit of an insider, the IRS may revoke an organization's exempt status if it finds the organization is no longer operating as a charitable organization due to excessive private inurement.[22]

Section 4958 and the accompanying regulations provide a "safe harbor" that results in a rebuttable presumption that amounts paid by the organization to its ODTKEs are reasonable. To establish the rebuttable presumption of reasonable compensation:

- The organization must appoint an "independent body" to review and determine the amount of compensation.
- The independent body must rely on appropriate comparability data to set the compensation amount.
- The independent body must contemporaneously document its decisions in setting compensation.

To overcome this presumption, if established, the IRS must develop sufficient contrary evidence to rebut the value of the comparability data on which the organization relied.[23]

Colleges and universities exempt under Section 501(c)(3) are subject to these rules on private benefit and private inurement. In the Final Report, the IRS found that the compensation for 94% of ODTKEs at the colleges and universities examined was set following procedures intended to satisfy the requirements for the rebuttable presumption. However, the IRS concluded that 20% of the institutions examined did not satisfy the standards established by the regulations. One significant shortcoming was the use of comparability data that derived, at least in part, from organizations that were not "similarly situated" to the institution in question. The Report states that factors such as location, endowment size, revenues, total net assets, number of students, selectivity in admissions, and age of the institution led agents to conclude that schools included in the comparability data were not in fact similar institutions. In addition, several colleges and universities relied on compensation studies that (1) did not adequately document how and/or why certain data was used or (2) did not specify whether the amounts reported included salary only or also reflected other types of taxable and non-taxable compensation.[24]

Organizations commonly rely on compensation consultants to provide this comparability data and to assist in setting compensation. Indeed, the IRS found that 50% of the schools examined used outside compensation consultants.[25] Use of a consultant did not necessarily result in the use of accurate comparability data, however. As discussed, 20% of the schools examined would not have successfully met the rebuttable presumption of reasonable executive compensation. Thus, reliance on a compensation consultant-and the comparability data provided by that consultant-is not enough by itself to fully protect an organization from the possibility of intermediate sanctions under the private inurement rules.

While the Final Report reaches certain conclusions about the scale of compensation paid by colleges and universities to various ODTKEs, it does not specify the number of institutions under examination actually found to have engaged in an excess benefit transaction subject to tax. Still, the Report's focus on executive compensation is consistent with other recent examinations of organizations outside the field of higher education. Revenue agents have imposed intermediate sanctions based on unreasonable compensation far more often in recent years than in the past. In informal discussions, IRS officials have indicated that compensation is a focus at all levels within the IRS, from the Examinations Division to the Office of Chief Counsel, and all tax-exempt organizations should therefore take heed of the executive compensation pitfalls identified in the Report.

Non-ODTKE compensation and employment tax issues

The Final Report also contains the findings of the IRS examinations with respect to compensation of non-ODTKEs at colleges and universities. The highest paid non-ODTKEs at these institutions were typically investment managers and sports coaches. In addition, the IRS found that department heads, faculty, and administrative and managerial employees were among other highly compensated non-ODTKEs at the schools examined.[26] Non-ODTKEs generally do not fall within the categories of individuals that are per se treated as "disqualified persons" for purposes of the intermediate sanctions rules in Section 4958, and as such, they may not rise to the level of insider who would be subject to the private inurement and excess benefit rules. Whether other employees can be considered insiders depends on the circumstances surrounding their employment. The regulations list various "facts and circumstances" that may indicate an individual's exercising substantial influence over the affairs of an organization. Depending on the interplay of such facts and circumstances, an individual may ultimately be deemed a "disqualified person" for purposes of Section 4958 and thus subject to intermediate sanctions.[27]

In addition, employees who are not ODTKEs still may be determined to have received a prohibited private benefit. As discussed, Section 501(c)(3) tax-exempt organizations are still subject to the broader prohibition on private benefit, which prohibits payment of excessive compensation for services rendered by an employee. As such, the IRS

may determine that an organization is conferring a private benefit on an employee based on the amount and structure of an individual's compensation package. Thus, the payment of excessive compensation to non-ODTKEs can still jeopardize an organization's tax-exempt status.

The inclusion of this additional data by the IRS in the Final Report provides important and useful information for colleges and universities when considering the appropriate salary structures for all highly compensated employees. Beyond the higher education industry, other exempt organizations should also take note of the Service's interest in non-ODTKE compensation. While not all organizations employ individuals like sports coaches, many organizations employ investment managers or other highly compensated non-officers that possess varying levels of control within the organization.

As part of the Project, the IRS also opened employment tax examinations at 11 of the 34 colleges and universities and retirement plan examinations at eight schools. Each of these examinations resulted in upward adjustments to wages and the assessment of additional taxes in excess of $7 million, with more than $160,000 in associated penalties. The reasons for these wage adjustments included common problems for all exempt organizations, such as failure to properly account for the value of personal use of automobiles, housing, and travel in the wage calculation, as well as failure to properly classify individuals as employees or independent contractors.[28]

Since the Final Report

On May 8, 2013, the U.S. House of Representatives Ways and Means Subcommittee on Oversight held a hearing to discuss the findings set forth in the Final Report. At that hearing, Rep. Charles Boustany (R-LA) called the information in the Final Report "troubling" and indicative of "almost universal noncompliance" with the Code's provisions on UBI and executive compensation by colleges and universities. He noted that the House Ways and Means Committee is considering revisions to the Code that may affect these provisions.

In her testimony before the Committee, then-Director of the IRS Exempt Organizations Division, Lois Lerner, assured members of the Committee that the IRS has already begun a second UBIT compliance project, focusing on exempt organizations that report UBI on their Forms 990 but do not then file Form 990-T. She stated that the IRS is currently planning a more expansive project, to begin next year, which will investigate whether issues identified in the Final Report are present across a greater portion of the tax-exempt sector. Ms. Lerner explained that the IRS views its projects and publications like the Final Report as a critical way to educate the exempt organizations community and thereby to increase and improve compliance.

Conclusion

The Final Report contains valuable lessons for colleges and universities as well as many other types of tax-exempt organizations. It is a guide for organizations subject to future compliance projects, a highlight reel of issues of interest in current IRS examinations, and a preview of issues on which the IRS will focus in future examinations. The Final Report and the entire Project are part of a broader pattern in IRS enforcement that has emerged over the last ten years. From the hospital and credit counseling compliance projects to the ongoing projects on foreclosure and mortgage services organizations and self-certified organizations, the IRS has consistently been using the compliance project format to conduct examinations and identify what it sees as likely widespread issues for all tax-exempt organizations. The Final Report for the Project thus provides a critically important blueprint to what the IRS will consider to be optimal compliance when conducting an examination.

Some of the lessons that all tax-exempt organizations should take from the Project include:

- If an organization receives a compliance check questionnaire as part of an IRS initiative, the organization should complete it and file it with the IRS. In the Project, 13 colleges and universities received, but did not complete, the questionnaire. The IRS opened examinations of all 13 schools. While the IRS states that completing a questionnaire is voluntary, it appears as though the failure to do so will automatically result in additional IRS scrutiny.
- When completing Forms 990 and 990-T and in determining an organization's UBIT liability, organizations should allow adequate time to consult with their tax counsel, to ensure that expenses are accurately allocated and that losses and NOLs bear the requisite relationship to the activity giving rise to UBI. If an organization takes the position that an activity is substantially related to its tax-exempt purposes, it should document the basis for its determination.

- An organization should consider using for-profit subsidiaries to house and conduct unrelated business activities that may be substantial. If a tax-exempt organization is contemplating substantial engagement in an unrelated business activity, a taxable, wholly owned subsidiary may be a helpful option to house the activity and protect the organization's tax-exempt status. Importantly, a taxable, for-profit subsidiary can pay some or all of its after-tax profits to the parent exempt organization in the form of dividends, all of which are tax-free to the parent. Additionally, if properly maintained, a for-profit subsidiary can isolate liabilities that may arise from the conduct of an activity, protecting the parent from legal risks associated with the activity. A variety of options exist for capturing unrelated business activities in new taxable entities, and these are options exempt organizations should review when considering a new endeavor that may be unrelated to the organization's exempt purposes.
- Organizations exempt under **Section 501(c)(3) or (c)(4)** should closely review their methods for setting executive compensation and their use of comparability data. The payment of unreasonable executive compensation can lead to the imposition of intermediate sanctions involving significant penalty taxes or even the revocation of exempt status. Executives at all tax-exempt organizations should be aware of the compensation approval process.
- Organizations should adopt and follow formal compensation policies to set executive compensation. The Final Report states that nearly two-thirds of the schools examined used compensation policies that applied to at least one of their ODTKEs during the tax years included in the exams. Having a formal compensation policy can assist an organization in establishing the rebuttable presumption of reasonable compensation.
- Organizations should seek outside advice and engage with the consultants, accountants, and lawyers that the organization hires. Even though the IRS may not agree with the conclusions reached by outside advisors with respect to UBI or compensation, going to the process of obtaining, analyzing, and utilizing outside opinions indicates a level of care and diligence exercised by the organization in deciding how to handle particular matters. When using an outside consultant for compensation data, organizations should ask questions about the origins of the data and ascertain whether the data reflects the practices of organizations that are truly similarly situated.
- Organizations that do not use compensation consultants should review their own procedures for selecting comparability data to ensure that such data reflects the practices of similarly situated entities. In its examinations, the IRS found that schools that did not use compensation consultants commonly relied on current surveys as their primary form of comparability data. If an organization does not use a compensation consultant, it should carefully examine the types of surveys used in setting compensation and consider the types of organizations reflected in those surveys.
- Smaller organizations that may not be able to hire outside experts to assist with UBI and executive compensation issues can still take steps to ensure compliance. Smaller institutions can receive substantial benefits from membership in a trade association of similar entities that can pool their resources and, collectively, hire appropriate experts to provide general information and develop guidelines for compensation and annual tax reporting.

Expect UBI and executive compensation issues to continue to garner attention from the IRS in the coming years. During the course of the Project, the IRS went to great lengths to educate its revenue agents about these issues and their consequences. Top IRS officials have already indicated that the agency will be conducting a more wide-ranging compliance project focusing on these areas in the future. Therefore, regardless of whether an examination is commenced through a compliance project or not, these are issues that will be at the forefront of an agent's focus during all future examinations.

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For questions or more information, please contact Margaret C. Rohlfing at *mcrohlfing@Venable.com*; Matthew T. Journy at *mtjourny@Venable.com*; or Yosef Ziffer at *yziffer@Venable.com*.

[1] "Colleges and Universities Compliance Project Final Report," available at www.irs.gov/pub/irs-tege/CUCP_FinalRpt_042513.pdf.

[2] The original questionnaire may be viewed at: www.irs.gov/pub/irstege/sample_cucp_questionnaire.pdf.

[3] Reg. 1.513-1(b).

[4] Section 512(a)(1) (defining unrelated business taxable income to mean "the gross income derived by any organization from any unrelated trade or business ... regularly carried on by it.").

[5] Reg. 1.513-1(b).

[6] Regs. 1.513-1(c)(1), (d).

[7] Final Report, *supra* note 1 at 11-12 (2013).

[8] NOLs are losses that are reported in one year and used to offset gains in past or future years. Colleges and universities, as well as other exempt organizations, often report NOLs resulting from unrelated business activities and use such amounts to mitigate their overall UBIT liability.

[9] IRM 7.27.6.2(1), IRM 7.27.6.2(2).

[10] Final Report, supra note 1 at 11-14.

[11] See, e.g., Rev. Ruling 81-69, 1981-1 CB 351 (where a service is offered at a price insufficient to recover costs, the activity is not conducted with a profit motive, and losses from the activity may not be used to offset gains from other, profitable unrelated business activities).

[12] Final Report, *supra* note 1 at 3.

[13] *Id.* at 13.

[14] *Id.* at 14.

[15] Reg. 1.503(c)(3)-1(d)(1)(ii).

[16] American Campaign Academy, 92 TC 1053, 1066 (1989).

[17] Ltr. Rul. 9615030.

[18] *See* Rev. Rul. 70-186, 1970-1 CB 128.

[19] Reg. 1.501(a)-1(c).

[20] IRM 7.76.3.11.1(1).

[21] IRM 4.76.3.11.2(3).

[22] H. Rep't No. 104-506, 104th Cong., 2d Sess. 56, fn. 15 (1996).

[23] Regs. 53.4958-6(a), (b).

[24] Final Report, *supra* note 1 at 4, 22-23.

[25] *Id.* at 22.

[26] *Id.* at 17-18.

[27] Reg. 53.4958-3(e)(2). These facts and circumstances include, but are not limited to, whether the person (1) founded the organization; (2) is a substantial contributor to the organization; (3) is compensated based primarily on revenues derived from activities of the organization, or of a particular department or function of the organization that the person controls; (4) has or shares authority to control or determine a substantial portion of the organization's capital expenditures, operating budget, or compensation for employees; (5) manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole; (6) owns a controlling interest (measured by either vote or value) in a corporation, partnership, or trust that is a disqualified person; or (7) is a non-stock organization controlled, directly or indirectly, by one or more disqualified persons.

[28] Final Report, *supra* note 1 at 19-21.

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AUTHORS:

Matthew T. Journy
mtjourny@Venable.com
202.344.4589

Yosef Ziffer
yziffer@Venable.com
410.244.7550

Jeffrey S. Tenenbaum
jstenenbaum@Venable.com
202.344.8138

TOOLS FOR BYPASSING IRS DELAYS IN EO APPLICATIONS

Organizations and their representatives missed opportunities to mitigate the consequences of the IRS' delays and requests for inappropriate information.

Recently, the IRS admitted that it employed inappropriate criteria to select certain applications for recognition of tax-exempt status for additional review. Just a few days after this admission, on May 14, 2013, the Treasury Inspector General for Tax Administration (TIGTA) issued a report (the "TIGTA Report"),[1] concluding that, due to ineffective management, the Service: (1) developed inappropriate criteria to identify applications for additional review, (2) substantially delayed processing certain applications, and (3) issued unnecessary information requests as a result of such criteria and delays. Further, the TIGTA Report noted that the specialists charged with reviewing the selected applications "lacked knowledge" about the permissible activities of tax-exempt organizations described in **Sections 501(c)(3) and (c)(4)**.[2] Predictably, in the aftermath of the TIGTA Report's publication, Congress and many sectors of the media have continued to rehash the particulars of this "scandal," looking to assign blame and find deeper connections between the Service's inappropriate criteria and other parts of the federal government, including the White House.

The purpose of this article is not to add to the noise surrounding the scandal. It will neither identify the parties at fault nor find the link between President Obama and the IRS selection of Tea Party organizations for additional scrutiny. It will not join the chorus of voices on either side of the aisle nor will it analyze who bears ultimate responsibility for the Service's internal structure and process. Rather, recognizing that the Service's inappropriate administration of tax-exemption qualification matters is not limited to the 296 completed applications reviewed under this program, and will not be entirely eliminated in the future, this article will discuss how organizations subject to extended IRS reviews can substantially mitigate the adverse effects of inappropriate enforcement efforts by the Service. Insofar as mismanagement, significant delays, and misinformed determinations specialists are potential issues in any IRS enforcement effort, practitioners must be equipped to combat the organizational ineffectiveness and bureaucratic inefficiency that can otherwise result in harm to clients applying for recognition of tax-exempt status.

Using the TIGTA Report as a point of departure, the discussion below identifies specific issues in the Service's review of requests for recognition of tax-exempt status and lists many of the common harms that can result from the Service's inappropriate actions. In that context, it then discusses proactive measures available to would-be

tax-exempt organizations to help them mitigate the harms caused by inappropriate IRS delays or inquiries.

Issues identified in the TIGTA Report

Notwithstanding the general media attention devoted to the Service's use of inappropriate criteria to select organizations for additional review, other issues highlighted in the TIGTA Report should generate greater concern on account of their potential to cause substantial harm to organizations. Indeed, the Code limits the extent to which organizations described in Sections 501(c)(3) and (c)(4) may engage in lobbying activities and intervene in political campaigns. As such, it is a legitimate function of the Service to exercise additional scrutiny when information within an application, including the organization's name, indicates that the subject organization may be engaged in an inappropriate amount of political campaign activity. Of the issues noted by the TIGTA Report, the mere existence of additional review prior to approval was not highlighted as an issue of concern. In fact, while it determined that 91 out of 296 completed applications did not indicate significant political intervention,[3] the TIGTA Report estimated that an additional 185 applications should have been identified by the IRS for additional review, but were not.[4] Thus, although the TIGTA Report noted that the method used by the IRS gave "the appearance that the IRS is not impartial in conducting its mission,"[5] mere identification of organizations meriting further review is not unusual or particularly remarkable. Rather, the greatest harm arose from ineffective management and a determinations unit whose specialists lacked sufficient knowledge. This resulted in the Service's failure to make determinations on cases for, in some cases, more than two years, as well as its request for inappropriate information in its review of these entities.

The IRS took too long

The cover letter to the TIGTA Report noted that "many organizations had not received an approval or denial letter for more than two years after they submitted their applications. Some cases have been open during two election cycles (2010 and 2012)."[6] This is substantially longer than the Service's stated goal "of processing applications within 121 days."[7] In fact, through its review of these applications for tax-exempt status, the Service failed to close more than half of the cases identified for additional review.

Through this exemption application review program, the Service identified 296 complete applications for additional review because the applications indicated that the organization may be engaged in an impermissible amount of political activity.[8] Of the 296 organizations identified, 108 (approximately 36%) received a determination letter recognizing tax-exempt status.[9] In addition to the 108 examinations that were closed upon the recognition of tax-exempt status, 28 organizations withdrew their applications. Finally, as of the close of the TIGTA investigation, 160 cases (approximately 54%) remained open and had been open between 206 and 1,138 calendar days, with the average length of time being 574 days as of 12/17/12.[10]

The Service did not explain why it failed to close more than half of the cases that it identified for additional review. It is notable, however, that the Service failed to issue a single adverse determination to any organization whose application was identified for additional review. Moreover, the TIGTA Report makes no reference to any proposed adverse determinations, written protests, or any other actions by the Appeals Division. This suggests that not only did the Service fail to issue final adverse determination letters, but it failed to even issue any proposed adverse determination letters. What makes the absence of any adverse or proposed adverse determination letters so troubling is the fact that these cases were identified for additional review because the Service's initial review indicated a significant risk that these organizations should not be recognized as exempt under either Section 501(c)(3) or (c)(4). In other words, the Service failed to even propose the issuance of a single adverse determination after spending an average of 574 days on cases that were identified because of a substantial risk that the applicants would not satisfy the requirements for tax-exempt status. That leaves observers to draw their own conclusions, three of which are: (1) the "cynical supposition" that the Service's administration of these cases was so inept that it incorrectly identified almost 300 organizations as demonstrating a substantial likelihood of failing to qualify for tax-exempt status, only to conclude that the organizations are, in fact, exempt; (2) the "conspiracy theorist's supposition" that the Service deliberately delayed the issuance of any determinations, adverse or otherwise, for some unknown, nefarious reason; and (3) the authors' supposition that the Service, unsure of about the litigating hazards of its position relating to proposed adverse determinations, deliberately added layer after layer of administrative review so as to avoid having to issue any ruling to these organizations.

There is no evidence to support any of the suggested suppositions. The first and second are hopefully, and likely, incorrect. With respect to the third possibility, however, this would not be the first time that the Service decided to confront uncertainty in litigation by adding multiple layers of administrative review and substantial delay in the hopes that an organization awaiting a determination letter or subject to a proposed revocation letter simply goes away. Recently, in the credit counseling compliance project, several organizations waited so long-nearly a decade-to receive a final determination letter relating to their examination that they actually filed a petition for a declaratory judgment in the Tax Court prior to receiving a final adverse determination letter. Additionally, when one considers the many errors identified in the TIGTA Report-inappropriate selection of organizations for additional review, the request of unnecessary and inappropriate data regarding the political activities of individuals working with these organizations, and the improper disclosure of taxpayer information-it is not inconceivable that the Service was more than a little concerned about the litigating hazards created by its review of these applications.

Unnecessary and inappropriate information

The issues relating to the Service's review of these organizations were not limited to delays of time. Its actions during that review were equally problematic. The report noted a "lack of management review, at all levels" and also that the "Determinations Unit specialists lacked knowledge" about permissible activities for tax-exempt entities described in Sections 501(c)(3) and (c)(4).[11] As a result of this lack of management review and knowledgeable Determinations Unit specialists, the TIGTA Report counted 98 organizations that received inappropriate and unnecessary requests for additional information.[12] Specifically, the TIGTA Report noted that the Service's requests for additional information included seven questions that were not necessary to make a determination of an organization's tax-exempt status, including:

- The names of donors.
- A list of all issues important to the organization and the organization's position regarding such issues.
- The roles and activities of the audience and participants other than members in a particular activity, and the type of conversations and discussions members and participants had during the activity.
- Whether an officer, director, etc., has run or will run for public office.
- The political affiliation of any officer, director, speaker, candidates supported, etc., and, their relationship with an identified political party.
- Information regarding employment, other than for the organization, including hours worked.
- Information regarding activities of other organizations, not just the relationship of such organizations to the applicant.

Consequences of the inappropriate actions

Tax advisors, beyond providing technical expertise, strive to position clients to realize their business, programmatic, and operational goals. Since "timing is everything," they risk angering and alienating clients if the time and logistical complexities of legal or regulatory requirements prevent those clients from achieving their desired outcomes. This phenomenon manifests itself regularly when clients must be informed that their applications for recognition of tax-exempt status will likely take six to 12 months, if not longer, to be processed by the IRS.[13] Moreover, on top of the standard processing delays that have become the "new normal" at the IRS, the further delays caused by the questioning tactics identified in the TIGTA Report added further insult to injury. Far beyond the universe of potential Section 501(c)(3) and (c)(4) organizations, many constituencies suffer as a result of the Service's present inability to process exemption applications expeditiously.

The delays and inappropriate information requests had a unique effect on three groups: (1) the organizations under review that applied for Section 501(c)(3) status, (2) the organizations that applied for Section 501(c)(4) status, and (3) the contributors to and officers of these organizations.

Applying for Section 501(c)(3) status

For an organization applying for recognition of tax-exempt status under Section 501(c)(3), protracted delays in IRS

review can prevent the organization from timely commencing its operations and, in some instances, jeopardize the organization's long-term viability.

As a practical matter, many new organizations awaiting confirmation of tax-exempt status commence fundraising activities even while their applications are pending. When engaging individual or corporate donors, the applicant organization can often provide sufficient comfort that its tax-exempt status will eventually be recognized. So long as an organization has applied for tax-exempt status within 27 months following the month of its formation, assuming that the IRS ultimately grants recognition of exemption, such recognition will apply retroactively to the organization's date of incorporation. More often than not, this information satisfies individual or corporate donors and such donors willingly take the small "leap of faith" that the IRS will, in fact, issue a favorable determination letter. Thus, the donors make contributions and claim charitable deductions, and in hindsight it eventually becomes clear that such contributions were made to a charitable organization exempt under Section 501(c)(3).

This approach, however, does not typically succeed with potential donations from private foundations (PFs) or donor-advised funds (DAFs). PFs and DAFs are subject to rules that prohibit taxable expenditures, and grants to organizations that are not classified under Section 501(c)(3) count as taxable expenditures unless the grantor (i.e., the PF or sponsoring organization that houses the DAF, as the case may be) exercises expenditure responsibility over those grants. Generally, as a matter of practice, PFs and sponsoring organizations simply refuse to award grants until a grantee demonstrates that the IRS has recognized it as a Section 501(c)(3) organization (and, in the case of PF grantors, as a public charity). Thus, newly-formed organizations may encounter increased difficulty in generating donations from otherwise-willing donors. This is particularly true as DAFs grow in popularity and more potential donors establish DAFs and choose to conduct their charitable giving through those vehicles.

For organizations whose early-stage operations require such grants-whether to hire staff, conduct programs, acquire charitable-use assets, or procure work space-the prolonged delay in receiving an IRS determination letter can severely handicap their development. Moreover, for publicly visible organizations whose creation and expected operations are well known to the communities they purport to serve, the ongoing delay as a result of IRS refusals to issue a determination letter can deteriorate public confidence and threaten the entity's viability.

In addition to initial inability to obtain adequate funding, prolonged delay in receiving a determination letter can also curtail the organization's ability to engage in certain activities and/or subject the organization to potential liabilities from which it would otherwise be protected. For example, many states impose their own registration requirements on new charities. This can be a requirement for procuring state-level tax-exemption, conducting fundraising activity, or transacting purchases free of sales tax. In many cases, as part of its registration process, a state will require the applicant organization to produce a copy of an IRS determination letter. Thus, if the IRS review process stretches over many months or years, the organization may be forced to delay its fundraising (or, alternatively, conduct fundraising in violation of state requirements), just as it must pay thousands of dollars in sales tax in connection with necessary purchases, transactions, and the like.

Similarly, several states have for years prohibited organizations from engaging in credit counseling activities within the state unless the organization was recognized as exempt under Section 501(c)(3). Recognition of exemption under Section 501(c)(3) protects organizations from lawsuits for violation of the Credit Repair Organizations Act,[14] which provides a private right of action for violations of its provisions. Thus, during an extended delay in reviewing an organization's application for recognition of tax-exempt status, an organization may be unable to participate in the very activities for which it was organized or may be subject to laws from which it would otherwise be exempt.

Finally, organizations victimized by unduly delayed IRS reviews stand to incur tens of thousands of dollars, if not more, in increased legal and other professional expenses. This is particularly true in circumstances like those considered in the TIGTA Report-multiple Service reviews of an application and requests for a substantial amount of additional information that may be inappropriate and unnecessary to determine the organization's tax-exempt status. In such situations, tax advisors spend significant time challenging IRS agents in response to unwarranted requests and in addressing lengthy lists of questions and demands for additional information. The applicant organization often feels that it has no choice but to incur these costs, because it sees no other option but to adhere to the Service's demands. For many new organizations, the resulting bills can throw yet another wrench into the process of beginning operations on solid financial footing.

Applying for Section 501(c)(4) status

Many of the problems listed above for potential Section 501(c)(3) organizations may also be encountered by newly-formed Section 501(c)(4) entities. For instance, the professional expenses and problems related to unnecessary requests for information affect organizations seeking recognition of exempt status under either Section 501(c)(3) or (c)(4). Moreover, while Section 501(c)(4) organizations do not seek to secure tax-deductible charitable contributions from donors, they may nevertheless encounter political donors or contractors that insist on verifying the organization's tax-exempt status prior to making a contribution or entering into a contract. This is a very important consideration for donors in light of the Supreme Court's decision in *Citizens United v. F.E.C.*,558 US 310, 175 L Ed 2d 753 (2010), and the role of Section 501(c)(4) entities in campaign financing. For these reasons, some of the organizations whose applications were identified for additional review, and whose determination was delayed by two election cycles, quite possibly had filed their applications with the specific purpose of addressing the concerns of potential donors. As such, new Section 501(c)(4) organizations may find themselves every bit as hamstrung in commencing operations as their Section 501(c)(3) counterparts that rely on grants from PFs or DAFs.

The common denominator in these situations? Undue delay on the part of the IRS causes real economic harm to the very organizations that, as a matter of policy, Congress has determined to be socially beneficial and therefore deserving of tax-exempt status. As a result, in its role as gatekeeper to ensure that fraudulent organizations do not inappropriately procure tax-exempt status for unsanctioned purposes, the IRS has instead effectively prevented individuals, families, and communities from accessing the benefits of organizations that seek tax-exempt status legitimately.

Finally, as the TIGTA Report noted, the "Determinations Unit specialists lacked knowledge of what activities were allowed by I.R.C. 501(c)(3) and I.R.C. 501(c)(4) tax-exempt organizations."[15] As such, the individuals charged with reviewing and making determinations of the exempt status of these applicants lacked a sufficient understanding of the law. This resulted in the Service's request for inappropriate and unnecessary information, which in turn increased the expense, delay, and adverse impact of the additional review. Additionally, by subjecting themselves to the extended review by individuals lacking sufficient knowledge of Section 501(c)(4), any of these organizations that satisfied the requirements for recognition of tax-exempt status were at risk of receiving a proposed adverse determination simply as a result of the reviewer's lack of adequate knowledge about the acceptable activities of organizations described in Section 501(c)(4).

Contributors and organization officers

In addition to the applicant organizations themselves, the contributors to, as well as the directors and officers of, such organizations likewise suffered adverse effects from the Service's requests for additional information. The focus of the additional information requests noted in the TIGTA report was on the identities of these individuals, as well as their political leanings and activities. The additional information requested by the Service focused on private information and, by virtue of including it in the administrative record for a tax-exempt organization, made such information publicly available. Thus, the Service's actions could have resulted in inappropriately publicizing the private speech and beliefs of individual citizens, simply on account of such individuals' association with an organization applying for recognition of exemption.

By exposing the private beliefs and activities of individual citizens to the public record, the Service's actions, intentionally or unintentionally, risked creating a "chilling effect" on the free speech of individuals whose private views became public. This is especially true with respect to donors to the Section 501(c)(4) applicants. With the recent changes to the legal landscape for organizations that engage in political activities, resulting in the rise of "super PACs," a primary appeal of making contributions to Section 501(c)(4) organizations was the anonymity that such contributions afforded donors. As such, it is reasonable to assume that a significant portion of the donors to Section 501(c)(4) organizations made contributions to those particular organizations specifically because they wanted to contribute to a cause in which they believe, but without being publicly linked to that cause. By effectively forcing organizations to publicly disclose the names of such donors, the Service eliminated the benefit of anonymity, which may in turn discourage individuals from fully participating in the political process in the future. Regardless of whether one believes that individuals or organizations should be able to make indirect anonymous contributions to political campaigns through Section 501(c)(4) organizations, the law currently allows such activity. The Service's

directive, as provided by the Code, is to enforce the law. Thus, by requesting and disclosing certain taxpayer information which identified the political beliefs and identities of individual citizens, the Service abused its authority.

What was done to mitigate organizational harm?

The TIGTA Report notes that, as of 12/17/12, 160 of the 296 identified organizations had yet to receive any determination from the Service, notwithstanding that the *average* delay had reached 574 days. Of the cases that remained open, 70 organizations applied for recognition of exempt status under Section 501(c)(3) and 90 organizations applied for recognition of Section 501(c)(4) status. However, despite the long delay and availability of other remedies, it appears as though few, if any, of these organizations took any action to expedite or remove the review of these applications from the Service's purview.

The TIGTA Report noted that, as of 5/31/12, the declaratory relief provided by Section 7428 was available to 32 of the organizations selected for review-approximately 46% of open Section 501(c)(3) cases-because those cases "were open more than 270 calendar days, and the organizations had responded timely to all requests for additional information."[16] Additionally, as of 12/17/12, only 3 of the 260 cases had been open for less than 271 days.[17] Thus, notwithstanding the fact that requests for more than 95% of the organizations seeking exemption under Section 501(c)(3) had been open for more than 270 days without a determination from the IRS, the TIGTA Report noted that "none of these organizations had sued the IRS, even though they had the legal right."[18]

As discussed below, the right to seek a declaratory judgment relating to tax-exempt status is reserved for organizations that apply for tax-exempt status under Section 501(c)(3). That being said, a different potential remedy remained available to organizations that applied for recognition of exempt status under Section 501(c)(4) -the fact that organizations described in Section 501(c)(4) are not actually required to file an application seeking recognition of tax-exempt status. Such organizations can simply self-certify that they do in fact qualify for such tax-exempt status. As such, any organization that had applied for tax-exemption under Section 501(c)(4) could have withdrawn its application and avoided the risk and expense associated with the Service's extremely long and burdensome review. However, despite the ease of such an action, the TIGTA Report noted that 90 organizations continued to wait on the Service for more than 200 days, with some waiting more than 1,100 days. Only 28 organizations opted to withdraw their application from IRS review.[19]

Finally, the TIGTA Report noted that 98 organizations received information requests that sought "irrelevant (unnecessary) information because of a lack of managerial review."[20] While 27 of these organizations were subsequently informed by the Service that they need not respond to such information requests, at least 71 organizations were required to respond. Also, while the TIGTA Report does not indicate what portion of the organizations provided the requested information, it appears that many organizations did so.[21] The TIGTA Report does not contain a record of any organizations expressly refusing to provide such information.

Based on the information provided in the TIGTA report, it appears that these organizations failed to take any significant action to curtail the extended IRS review of their applications or avoid responding to the overbroad and inappropriate information requests.

Was there any advantage to enduring the review?

With so many organizations enduring the Service's extended review of their applications for exempt status, it is important to ask why these organizations subjected themselves to that review and whether there were any potential benefits from doing so. The authors are not aware of any advantages of undergoing a prolonged IRS review. First, there is no tax or other advantage to being "under IRS review" as opposed to being recognized as exempt.[22] Second, after more than a year in a state of limbo without any correspondence from the IRS, the organizations should have begun to wonder whether the Service would provide an unbiased review of their applications. In fact, the TIGTA investigation arose because several organizations complained to members of Congress about the Service's biased treatment. Thus, if these organizations were already questioning whether the IRS was biased, it may have been in their best interest to remove their cases from the Service's review by seeking a declaratory judgment from a less biased judge or by self-certifying their Section 501(c)(4) status.

Another consideration for organizations that applied for Section 501(c)(3) status should have been the impact of removing the case from the Service's review. By forcing the issue before a court of applicable jurisdiction, these organizations could have brought public attention to their plight long before the TIGTA Report was published in June 2013. Also, this could have worked as a diversion in the review of their cases. The mere fact that these organizations were selected for review is an indication of the existence of some questions regarding their qualification for tax-exempt status. By bringing a case to court after such an extended period of inaction, the initial question that would be presented to the court would relate to the Service's unexplained delays, rather than any questions pertaining to the organization's qualification for tax-exempt status. This would have put the Service in the position of needing to justify its substantial delays in a public forum, which would have accomplished one of two things. The more likely result is that the IRS would have been prompted to settle the case to avoid the public embarrassment that has unfolded in the aftermath of the TIGTA Report. Alternatively, litigation would have brought public attention to the Service's practices years before the TIGTA Report was published.

What could have been done?

As representatives of tax-exempt organizations, advisors' responsibilities exceed merely navigating the IRS administrative process and responding to requests for information when the IRS eventually reviews an application. Rather, they are responsible for achieving the results that best serve the clients' interests. As such, to the extent that additional avenues-inside the IRS and out-provide possible means to achieve the desired results in an effective and efficient manner, advisors should at a minimum present those options to clients for their consideration. Moreover, clients must be given the information and context necessary for them to make an informed decision on whether to pursue such options, particularly when they represent a departure from common practice.

Declaratory judgment

Once it became clear that the IRS review of applications of Section 501(c)(3) organizations was not going to be approved under the standard process, organizations confident of their position should have considered seeking a declaratory judgment.

Under Section 7428, the United States Tax Court, the United States District Court for the District of Columbia, and the United States Court of Federal Claims have concurrent jurisdiction to issue a declaratory judgment in the case of an actual controversy with respect to a determination or the Service's failure to make a determination regarding the initial qualification of an organization described in Section 501(c)(3). It is important to note that this remedy is available for Section 501(c)(3) organizations only; it is not available to other types of exempt organizations, including those described in Section 501(c)(4).

To meet the jurisdictional requirements necessary to obtain a declaratory judgment, Section 7428(a) provides that there must be "(1) an actual controversy (2) involving a determination or a failure to make a determination by the Secretary (3) with respect to an organization's initial or continuing qualification or classification as an exempt organization."[23] Additionally, Section 7428(b) provides that a declaratory judgment shall not be issued unless the court "determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service."

Actual controversy. Generally, courts have interpreted the "actual controversy" requirement to mean that "the power to issue declaratory judgments does not extend to advisory opinions on abstract or hypothetical facts, which do not involve any case or controversy."[24] As such, courts have determined that they lack jurisdiction over cases in which the Service has "not spoken finally with regard to [the] petitioner's status";[25] and that they do not have jurisdiction over cases in which the Service merely threatens revocation if an organization engages in a particular activity in the future.[26] Finally, the courts have ruled that the scope of their jurisdiction to issue declaratory judgments is limited to controversies related to initial or continuing classification "with respect to exempt status, the private foundation status or the private operating foundation status (as defined in 4942(j)(3)) of an organization."[27] As such, courts have determined that they lack jurisdiction over questions of donor deductibility of charitable contributions.[28]

With respect to the organizations discussed in the TIGTA Report, the issue under consideration within the IRS was whether the organizations were exempt under Section 501(c)(3). Thus, any dispute over such matters would constitute a controversy over which the courts have jurisdiction pursuant to Section 7428 .

Failure to make a determination. Under Section 7428(a)(2), in order for a court to have jurisdiction to make a declaratory judgment due to the Service's failure to make a determination, an organization must first make a request for such a determination. Generally, this is done by submitting a Form 1023, "Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code ."

Courts considering this issue have noted that neither the statute nor the regulations defines either a "failure to make a determination" or a "request for a determination."[29] However, courts considering whether a request for a determination was made have all recognized that the filing of a substantially complete application within the meaning of Regs. 601.201(n)(7)(iv)(a) and (b) is a "request for a determination."[30] When considering whether the Service has failed to make a determination, the courts have looked to the legislative history of Section 7428, which provides that the courts will have jurisdictional authority over an issue where the Service has failed to act on a request for a determination.[31]

In the present situation, the reason for the substantial delays was the Service's identification of each of these entities based on the information provided in the Form 1023. As such, it is clear that the organizations in question made a "request for determination." Moreover, the TIGTA Report noted that the Service had failed to act with respect to any of these requests for a determination since the Service failed to make a determination with respect to these organizations.

Exhaustion of administrative remedies. An organization is deemed to have exhausted its administrative remedies as of the earlier of: (1) the notice of a final determination or (2) the expiration of the 270-day period after filing its application for recognition of tax-exempt status. Specifically, Section 7428(b)(2) provides that an organization "shall be deemed to have exhausted its administrative remedies with respect to a failure by the Secretary to make a determination with respect to such issue at the expiration of 270 days after the date on which the request for such determination was made if the organization has taken, in a timely manner, all reasonable steps to secure such determination." In *BBS Associates*, 74 TC 1118, 2 EBC 2413 (1980), noting the Service's failure to issue a determination of tax-exempt status after 21 months, the court concluded that the applicant organization had exhausted its administrative remedies after an "inordinately long delay by the [Service] in processing the petitioner's application and arriving at a final determination."[32]

Although the 270-day period creates a presumption that an organization has exhausted its administrative remedies, the expiration of 270 days alone does not satisfy the jurisdictional requirements for a declaratory judgment.[33] An organization must have also taken, "in a timely manner, all reasonable steps to secure a ruling or determination."[34] When determining whether an organization has exhausted its administrative remedies under this standard, the courts have looked to the legislative history, one court noting that the purpose of this requirement is "to provide the Court with a full and complete administrative record on which to base its decision."[35] Moreover, the legislative history provides that an organization will not have exhausted its administrative remedies "if the organization fails to comply with a *reasonable* request by the Service to supply the necessary information on which to make a determination."[36] However, these additional requirements have not been read to require organizations that have not received a determination within 270 days to wait to file a petition for declaratory judgment until they have had the opportunity to exhaust all administrative remedies within the Service.

In *Gladstone Foundation*, 77 TC 221, 226 (1981), the court noted that Section 7428 "was intended to provide a remedy for hardships caused by undue administrative delays."[37] As such, in considering cases where 270 days have lapsed, courts have not looked to whether organizations have exhausted every potential administrative remedy. Rather, courts have looked to whether the organization "has taken timely, reasonable steps to secure a determination."[38] Thus, in the present situation, as of the publication of the TIGTA Report, the organizations discussed in the report likely would have been deemed to have exhausted their administrative remedies as of the expiration of 270 days, even though the organizations whose exemption was under consideration within the Service had not completed all available administrative processes within the Service.

Self-certification

Section 7428 does not apply to Section 501(c)(4) entities[39], and therefore its provisions do not extend to any entity that has submitted a submitted Form 1024 for recognition of exemption under Section 501(c)(4) (or any other 501(c) classification[40]). As such, organizations that file a Form 1024 are not permitted to seek a declaratory judgment in situations where the IRS refuses to issue a determination. Nevertheless, while a declaratory judgment is not available to such organizations, there are other options to avoid unreasonable IRS demands or delays. In particular, Section 501(c)(4) organizations can make use of the fact that they generally are not required to seek an IRS determination on their tax-exempt status, and need not await a formal IRS determination at all. Such organizations can instead "self-certify" as tax-exempt.

Section 508(a) requires most organizations seeking treatment as Section 501(c)(3) organizations to notify the Service of their intent to be treated as exempt by filing a Form 1023. However, Section 508(a) does not extend to other types of Section 501(c) tax-exempt entities. Therefore most such organizations may, of their own volition, determine that they meet the applicable parameters of a desired category of tax-exemption and conduct their business accordingly.[41] Indeed, the Internal Revenue Manual states that actual tax-exempt status arises as a matter of law; an IRS determination letter merely provides formal recognition of such status.[42] Thus, while Section 501(c)(4) organizations must file an annual Form 990 information return, they need not formally apply for tax-exempt status by submitting Form 1024. Nevertheless, many organizations opt to file Form 1024 in any event, whether for "peace of mind," to avoid future IRS allegation of taxable status, or to demonstrate formal IRS recognition for other purposes (*e.g.*, as a condition of obtaining state-level exemption, or to satisfy the needs of a potential contributor or contract-party).

Organizations subject to lengthy IRS delays or inappropriate questioning in response to a Form 1024 submission could opt to rely on self-certification and withdraw their previously submitted applications. Doing so would effectively end the IRS review, thus saving the financial and human resources that would otherwise be devoted to responding to the Service's inquiries. Similarly, to the extent that the IRS poses questions that may involve sensitive information, such as the identities of certain individuals as well as their political leanings and political activities, withdrawal of the application allows the organization to ensure that such information remains confidential and does not become inappropriately disclosed and thereby part of a publicly disclosed record. Of greatest importance, cancelling the organization's request for recognition of exemption avoids the risk that an under-informed determinations specialist, perhaps one not adequately familiar with the rules governing Section 501(c)(4) organizations, will incorrectly issue an adverse determination letter, refusing to recognize the organization's tax-exempt status.

Notwithstanding these potential benefits, the organization should confer with counsel to ensure that a decision to terminate a request for recognition of exemption will not unwittingly subject it to other, undesired consequences. For example, if state-level income tax exemption requires the organization to produce a copy of a favorable IRS determination letter, the potential state-level tax exposure may mandate that the organization proceed with its request for federal recognition. Similarly, depending on the organization's business model and expected sources of revenues, a favorable IRS determination letter may prove necessary.

However, once it became clear that the IRS review of applications of Section 501(c)(4) organizations were not going to be reviewed under the standard process for review of Forms 1024, organizations that were not seeking a determination letter to satisfy a donor or contractor requirement should have evaluated their reasons for filing a Form 1024 and considered whether it was in their best interest to withdraw their applications and self-certify their status as Section 501(c)(4) organizations. In the face of a prolonged IRS review, such as the one to which that the applicants at issue were subjected, self-certification offers distinct advantages.

Refuse to provide inappropriate information

When dealing with requests for information related to applications for tax-exempt status, advisors must remain knowledgeable and aware of: (1) the type of information that the IRS needs in order to make the requested determination, and (2) the purpose for which additional information is being requested. As such, upon receiving a request for information that the IRS does not need in order to make a determination, or whose purpose appears

unclear, advisors should ask the IRS for clarity about the function of the requested information. In some instances, it may be appropriate to protect clients' interests by advising them not to provide such information.

The mere fact that the IRS requests information does not mandate that such information be shared. In some instances, the intended information is not clearly represented by the request and a discussion with the IRS may provide insight into the actual information desired or the previously unknown reason that the information is requested. Alternatively, after informing the IRS that a particular request is inappropriate, the IRS may choose to withdraw its request. By limiting the scope of information provided to the IRS, attorneys can help clients protect donors and other key individuals, as well as limit the likelihood that the IRS will rely on inappropriate information to make an adverse determination.

In the case of Section 501(c)(3) applicants, the refusal to provide information requested by the Service may raise concerns related to whether such a refusal may prevent an organization from obtaining a declaratory judgment under Section 7428 . However, though organizations are required to exhaust their administrative remedies, the legislative history and cases interpreting this statute are in agreement that the exhaustion of administrative remedies only requires organizations "to comply with a *reasonable* request by the Service to supply the *necessary* information on which to make a determination."[43] Therefore, the exhaustion of administrative remedies standard does not require organizations to respond to requests that are neither reasonable nor necessary, such as those discussed in the TIGTA Report.

Aftermath

In the aftermath of the Service's review of these issues, two significant developments have occurred. First, the IRS responded to criticism over its handling of certain Section 501(c)(4) cases by creating a process for expedited treatment of the organizations subject to this review program. Second, several of the organizations have acted on the TIGTA Report's advice and brought cases seeking a declaratory judgment, as well as other relief, in district courts throughout the country.

IRS response

In response to the well-publicized mishandling of Form 1024 applications, the IRS has recently offered a streamlined "hybrid" approach, combining the self-certification model with a formal recognition of tax-exempt status. For organizations whose applications had, as of 5/28/13, been pending for more than 120 days, so long as these applications do not raise questions of private inurement, the IRS has issued or will issue Letter 5228[44], which invites the applicant organizations to "self-certify" and make the following representations under penalties of perjury:

- The organization devotes 60% or more of its spending and time to activities that promote "social welfare" within the meaning of Section 501(c)(4).
- The organization devotes less than 40% of its spending and time to political campaign intervention.
- The organization certifies that the above-stated percentage threshold apply for past, present, and anticipated future activities of the organization.

If an organization is able and willing to make these representations, it may return the appropriate signed pages to the IRS. The IRS has committed to issue a favorable determination letter within two weeks of receiving the signed representations. Organizations desiring to take advantage of this expedited process must return their signed representations within 45 days. That being said, this expedited process is optional, and organizations may choose to continue seeking recognition of tax-exemption under their previously submitted Form 1024 through normal processes.

Tax litigation

One purpose of this article is to explain that more should have been done by organizations and their representatives to obtain a quicker determination from the IRS, including seeking a declaratory judgment from a court of appropriate jurisdiction. As such, it may be surprising that the authors do not believe that the majority of claims that have been filed to date as a result of this exemption application review program are viable cases. Nevertheless,

based on an analysis as to whether a court will have jurisdiction over the issues raised in the complaints that have been filed since the publication of the TIGTA Report, it appears that many of the claims may not prove successful.

Since the TIGTA Report was published, three cases have been filed by organizations seeking declaratory, injunctive, and other relief resulting from the Service's review of applications identified for additional review. *NorCal Tea Party Patriots v. IRS, et al.* ("*NorCal Tea Party*")[45] is a class action filed in the U.S. District Court for the Southern District of Ohio seeking monetary damages resulting from the prolonged IRS review of the exemption applications. *True the Vote, Inc. v. IRS, et al.* ("*True the Vote*")[46] was filed in the U.S. District Court for the District of Columbia seeking declaratory, injunctive, and monetary relief. Also filed in the U.S. District Court for the District of Columbia was *Linchpins of Liberty, et al, v. U.S., et al.* ("*Linchpins of Liberty*")[47], which seeks declaratory, injunctive, and monetary relief on behalf of 25 organizations that were subject to the Service's prolonged examination of their applications for tax-exempt status.[48]

Filed on a behalf of a single organization that made a request for tax-exempt status that was not acted on, the *True the Vote* case provides the closest example of a traditional suit for declaratory judgment. The case was filed in a court of appropriate jurisdiction, the U.S. District Court for the District of Columbia, and the claim for relief expressly seeks a declaration that the organization qualifies both as an organization described in Section 501(c)(3) and as a public charity described in Sections 509(a)(1) and 170(b)(1)(A)(vi). In addition to declaratory relief, the complaint filed by True the Vote seeks: (1) a declaration that the Service's policies were unconstitutional, (2) a permanent injunction prohibiting IRS enforcement using similar policies, (3) a permanent injunction prohibiting the Service from illegally inspecting True the Vote's return information, (4) an order that the Service must implement the recommendations of the TIGTA Report, (5) damages for each unauthorized inspection of True the Vote's return information, (6) actual and punitive damages related to True the Vote's expenses related to the Service's review of its Form 1023, and (7) reasonable attorney fees.

The *Linchpins of Liberty* case represents a far less traditional request for declaratory judgment. First, it was filed on behalf of 25 organizations, two of which applied for recognition of Section 501(c)(3) status while 23 applied for recognition of Section 501(c)(4) status. Second, the grounds for the declaratory relief are primarily focused on the Service's alleged violations of the plaintiffs' constitutional rights-specifically the First and Fifth Amendments-though the complaint does seek Section 7428 declaratory relief as well. In addition to the declaratory relief and constitutional issues, the plaintiffs requested a declaration that the Service violated the Administrative Procedures Act (APA)[49] as well as an injunction that permanently prohibits the Service from unlawfully targeting the plaintiffs and compelling the Service to recognize the plaintiffs' tax-exempt status. Also, similar to the complaint in *True the Vote*, the complaint in the *Linchpins of Liberty* case seeks damages for the unauthorized inspection of return information, actual and punitive damages related to the Service's prolonged review of the plaintiffs' applications for tax-exempt status, and reasonable attorney fees. Finally, the *Linchpins of Liberty* complaint demands a jury trial.

Taken separately, with respect to the declaratory and injunctive relief requested, a court is far more likely to have the jurisdictional authority over the *True the Vote* case than over the *Linchpins of Liberty* case, because the *True the Vote* complaint is related to a single organization entitled to the declaratory relief requested pursuant to statutory authority, Section 7428 . On the other hand, the *Linchpins of Liberty* complaint includes only two organizations that are entitled to the statutory relief provided by Section 7428, and 23 organizations that fail to qualify for such relief because they sought recognition of exempt status under Section 501(c)(4), not Section 501(c)(3). Additionally, because of the multitude of plaintiffs and myriad issues raised in the *Linchpins of Liberty* complaint, the complaint is unable to clearly demonstrate the court's jurisdiction over the two plaintiffs who would otherwise be entitled to the declaratory relief. Taken together, these cases present a variety of interesting though ultimately untenable arguments seeking declaratory and other relief, including: (1) a declaration and injunction based on violations of the plaintiffs' constitutional rights, (2) a declaration and injunction based on violations of the APA, (3) declaratory relief sought by organizations that applied for recognition of Section 501(c)(4) status, and (4) a request for a jury trial.

Declaratory and injunctive relief based on violations of constitutional rights

The constitutional violations raised in these complaints include violations of the Free Speech Clause of the First Amendment, violations of the Due Process Clause of the Fifth Amendment, and violations of the right to free association implicit in the First and Fifth Amendments. Courts have considered these issues before, ruling that the

Service's denial of exemption does not violate these rights and, in light of the limitations of the Anti-Injunction Act (AIA)[50] and the Declaratory Judgment Act (DJA)[51], the court lacks authority to enjoin the Service from enforcement of the Code pursuant to such claims.

First, the specific issue of whether denial of tax-exempt status was a violation of First or Fifth Amendments was considered by the D.C. Circuit in *Taxation with Representation of Washington v. Blumenthal*, 48 AFTR 2d 81-5244, 81-1 USTC ¶9329 (D.C. Cir., 1981). In *Taxation with Representation*, the court rejected the argument that the failure to grant an organization's tax-exempt status violated either the First or Fifth Amendments. With respect to the First Amendment, the court noted that it was bound by a prior decision in which it cited the Supreme Court's decision in *Cammarano*, 3 AFTR 2d 697, 358 US 498, 3 L Ed 2d 462, 59-1 USTC ¶9262, 1959-1 CB 666 (1959)[52], holding that the taxpayers were "not being denied a tax deduction because they engage in constitutionally protected activities, but are simply being required to pay for those activities entirely out of their own pockets as everyone else engaging in similar activities is required to do."[53]

Second, the relief requested with respect to each of these counts is a declaratory judgment regarding the rights of the parties. However, in its 1974 decision in *"Americans United," Inc.*, 33 AFTR 2d 74-1289, 416 US 752, 40 L Ed 2d 518, 74-1 USTC ¶9439, 1974-2 CB 401 (1974), the U.S. Supreme Court considered very similar arguments and expressly determined that it lacked the jurisdictional authority to grant such declaratory relief. Specifically, the Court ruled that such relief was prohibited by the DJA, which generally authorizes suits for declaratory judgment in cases of actual controversy "except with respect to federal taxes,"[54] and the AIA, which generally provides that "no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed."[55] Based on these provisions, the Court expressly determined that it lacked the jurisdictional authority to grant the requested relief, even though the it included a lengthy discussion about the harm to which the plaintiffs were subjected, going so far as to suggest that Congress act to permit such suits. Shortly thereafter, Congress passed Section 7428 to provide an express exception to the DJA in cases of an actual controversy relating to an organization's initial or continuing qualification for tax-exempt status under Section 501(c)(3). Therefore, based on the Supreme Court's express ruling in *"Americans United," Inc.*, it is clear that the courts lack jurisdiction to grant the requested declaratory and injunctive relief granted in the present cases.

Declaratory and injunctive relief based on violation of the APA

Obtaining declaratory and injunctive relief based on violations of the APA is also problematic. The relief sought includes a declaration of the rights of the parties and a permanent injunction that: (1) prohibits the IRS from future enforcement and (2) mandates that the IRS immediately recognize as exempt plaintiffs that are not currently recognized as exempt.

Generally, the APA provides that a "person suffering legal wrong because of agency action, or adversely affected or aggrieved by agency action within the meaning of a relevant statute, is entitled to judicial review thereof," and allows courts to issue an injunction against a federal regulatory agency where there is a violation of an agency's published administrative procedures that causes irreparable harm to a taxpayer.[56] However, section 702(2) provides that the APA does not confer authority to grant relief if any other statute "expressly or impliedly forbids the relief which is sought."

The situation presented here is similar to the situation that the Supreme Court considered in *Bob Jones University v. Simon*, 33 AFTR 2d 74-1279, 416 US 725, 40 L Ed 2d 496, 74-1 USTC ¶9438, 1974-1 CB 354 (1974). In *Bob Jones University*, the Supreme Court ruled that a suit seeking an injunction pertaining to an organization's tax-exempt status "falls squarely within the literal scope of the AIA."[57] Thus, courts will generally lack the authority to issue such an injunction unless one of the express exceptions to the AIA is met. As the claims asserted in the *Linchpins of Liberty* case were not made pursuant to one of the express exceptions to the AIA, similar to *Bob Jones University*, it is unlikely that the plaintiffs will be able to obtain the requested injunctive relief.

There is one non-statutory exception to the AIA prohibition. In *Enochs v. Williams Packing & Navigation Co.*, 9 AFTR 2d 1594, 370 US 1, 8 L Ed 2d 292, 62-2 USTC ¶9545, 1962-2 CB 349 (1962), the Supreme Court ruled that, if one of the express statutory exceptions did not apply, courts lack the authority to issue an injunction unless the taxpayer can

show both that: (1) the proposed government action will cause irreparable injury "such as the ruination of the taxpayer's enterprise," and (2) "it is clear that under no circumstances could the government ultimately prevail."[58] The *Linchpins of Liberty* complaint does not appear to satisfy this "extraordinary circumstances" exception created by the Supreme Court in *Williams Packing & Navigation*. Therefore, the court will most likely lack the authority to grant the injunctive relief requested under the APA.

Declaratory relief requested by Section 501(c)(4) applicants

In the *Linchpins of Liberty* case, 23 of the 25 plaintiffs fail to meet these requirements. Only two of the plaintiffs applied for recognition of Section 501(c)(3) status; the others applied for recognition of Section 501(c)(4) status. As such, as discussed above, all but two of the plaintiffs in this suit are not entitled to the requested relief under Section 7428 .

Request for a jury trial

The *Linchpins of Liberty* complaint requested a jury trial. However, pursuant to *Synanon Church*, 51 AFTR 2d 83-979, 557 F Supp. 1329, 83-1 USTC ¶9230 (DC D.C., 1983), a jury trial is not permitted in declaratory judgment cases brought under Section 7428 .

To summarize, the *True the Vote* and *Linchpins of Liberty* cases raise many interesting questions related to the Service's review of applications identified for additional review. However, due to the courts' limited authority to enjoin the Service under the AIA or to issue declaratory judgments against the Service under the DJA, it is unlikely that a court will consider the merits of many of the issues raised in these cases.

Conclusion

During the Service's review of the exemption applications of organizations deemed to be at risk of engaging in impermissible political activities, the organizations and their representatives could have better availed themselves of methods to mitigate the consequences of the Service's substantial delays and requests for inappropriate information. While it may be too late to undo harm that has already befallen those organizations, a better understanding of non-traditional options available to tax-exempt organizations can be used by future applicants to avoid falling prey to similar circumstances.

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For questions or more information, please contact Matthew T. Journy at mtjourny@Venable.com; Yosef Ziffer at yziffer@Venable.com; or Jeffrey S. Tenenbaum at jstenenbaum@Venable.com.

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This article is not intended to provide legal advice or opinion and should not be relied on as such. Legal advice can only be provided in response to a specific fact situation.

[1] Treasury Inspector General for Tax Administration, "Inappropriate Criteria Were Used to Identify Tax-Exempt Applications for Review," (5/14/13), Reference Number 2013-10-053 ("TIGTA Report"), available at www.treasury.gov/tigta/auditreports/2013reports/201310053fr.pdf.

[2] TIGTA Report, *supra* note 1 at 18.

[3] TIGTA Report, *supra* note 1 at 10.

[4] TIGTA Report, *supra* note 1 at 9. It appears as though 19 of these organizations were recognized as exempt under Section 501(c)(3) and 89 were recognized as exempt under Section 501(c)(4).

[5] TIGTA Report, *supra* note 1 at 6.

[6] TIGTA Report, *supra* note 1 at 11.

[7] TIGTA Report, *supra* note 1 at 1.

[8] TIGTA Report, *supra* note 1 Report at 10.

[9] TIGTA Report, *supra* note 1 at 14.

[10] TIGTA Report, *supra* note 1 at 11.

[11] TIGTA Report, *supra* note 1 at 18.

[12] TIGTA Report, *supra* note 1 at 20.

[13] www.irs.gov/Charities-&-Non-Profits/Where-Is-My-Exemption-Application.

[14] 15 U.S.C. 1679 *et seq.*

[15] TIGTA Report, *supra* note 1 at 18.

[16] TIGTA Report, *supra* note 1 at 16.

[17] TIGTA Report, *supra* note 1 at 15.

[18] TIGTA Report, *supra* note 1 at 16.

[19] The TIGTA Report does not indicate the portion, if any, of the 28 withdrawn applications that were applications for recognition of tax-exempt status under Section 501(c)(4). Additionally, the report does not provide any information related to the reason such applications were withdrawn.

[20] TIGTA Report, *supra* note 1 at 18.

[21] It is clear that some of the organizations responded to the unnecessary requests because the TIGTA Report noted that "EO function officials informed us that they decided to destroy all donor lists that were sent in for potential political cases that the IRS determined it should not have requested." TIGTA Report, *supra* note 1 at 19.

[22] It is notable that there may be several advantages to being a taxable organization as opposed to being an exempt organization, including a lack of operational oversight by the IRS and the freedom to engage in a variety of activities that are impermissible for tax-exempt organizations. However, such advantages are not relevant here because each of the organizations in question applied for recognition of tax-exempt status. As such, the comparison at issue is not between a taxable organization and an exempt organization; rather, it is the comparison between an organization recognized as exempt and one that is seeking recognition of that status.

[23] Gladstone Foundation, 77 TC 221, 226 (1981).

[24] AHW Corp., 79 TC 390, 396 (1982) (holding that the court lacked jurisdiction to issue a declaratory judgment with respect to whether an organization recognized as exempt could engage in a particular activity without jeopardizing its exempt status).

[25] *Id.* at 393.

[26] See New Community Senior Citizen Housing Corp., 72 TC 372 (1979); AHW Corp., *supra* note 24; Urantia Foundation, 50 AFTR 2d 82-5465, 684 F2d 521, 82-2 USTC ¶9512 (CA-7, 1982).

[27] CREATE, Inc., 47 AFTR 2d 81-641, 634 F2d 803, 81-1 USTC ¶9152 (CA-5, 1981).

[28] *Id.*

[29] Anclote Psychiatric Ctr., 98 TC 374, 377.

[30] See N.Y. County Health Services Review Org., 45 AFTR 2d 80-1552, 80-1 USTC ¶9398, 80-1553 (D.C. Cir., 1980) (holding that "[u]ntil such time as the Service either rules on plaintiff's Form 1023 request for determination, or fails to act on such a request within 270 days of its filing, this Court lacks subject matter jurisdiction"); B.H.W. Anesthesia Foundation, 72 TC 681 (1979); Natl Paralegal Inst. Coalition, TC Memo 2005-293, RIA TC Memo ¶2005-293, 90 CCH TCM 623 (2005).

[31] Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976* (hereinafter, "the Blue Book"), page 405.

[32] BBS Associates, 74 TC 1118, 2 EBC 2413, 1122 (1980).

[33] See Prince Corp., 67 TC 318, 1 EBC 1229 (1976) (interpreting Section 7476, the employee-plan counterpart to Section 7428, rejecting the petitioner's argument that the Code creates a per se test for exhaustion of administrative remedies based on the mere lapse of 270 days); Clawson, TC Memo 1993-174, RIA TC Memo ¶93174, 17 EBC 1193, 65 CCH TCM 2452, (holding that even when the Service made an adverse determination, the court lacked jurisdiction to issue a declaratory judgment because the taxpayer did not exhaust its administrative remedies because it failed to protest the proposed revocation); Natl Paralegal Inst. Coalition, *supra* note 30 (holding that the "exhaustion of administrative remedies is predicated on the filing of a 'substantially completed' application" and that where an organization fails to file a completed application or take any steps to perfect the incomplete application, the organization has not exhausted its administrative remedies); McManus, 93 TC 79 (1989) (holding that even when the Service made an adverse determination, the court lacked jurisdiction to issue a declaratory judgment if the taxpayer did not take any steps to obtain a favorable ruling).

[34] Reg. 601.201(n)(7)(v)(b).

[35] Gladstone Foundation, *supra* note 23.

[36] The Blue Book at 405 (emphasis added); see also Animal Protection Inst., 42 AFTR2d 78-5850 (Ct. Cl. 1978) (noting that the exhaustion of administrative remedies only required that organizations supply "any *reasonable* information requested by the Service").

[37] Gladstone Foundation, *supra* note 23 at 236.

[38] Anclote Psychiatric Ctr., *supra* note 29 at 382; see also Gladstone Foundation, *supra* note 23 at 235 (stating that an organization "may be deemed to have exhausted its administrative remedies due to [the Service's] purported failure to process its request expeditiously"); Prince Corp., *supra* note 33 at 328 (holding that "[a]fter 270 days have passed a petitioner need only demonstrate that progress is severely hampered due to causes beyond its control").

[39] See Christian Coalition of Florida, Inc., 108 AFTR 2011-7157 (CA-11, 2011) (holding that the court lacked jurisdiction to issue a declaratory judgment under Section 7428 to an organization seeking Section 501(c)(4) status because "it is clear that Congress has granted organizations claiming 501(c)(4) tax-exempt status fewer avenues for judicial relief than those organizations seeking 501(c)(3) status").

[40] For purposes of this discussion, the authors will focus on Section 501(c)(4) organizations.

[41] Notwithstanding this general rule, based on sections other than Section 508, certain other types of tax-exempt entities may not self-certify. Such organizations include Section 501(c)(4) credit-counseling agencies, as well as organizations seeking exemption under Sections 501(c)(9), (c)(17), and (c)(20).

[42] IRM 7.25.1.1(1). In this regard, note that both Form 1023 and Form 1024 are titled "Application for *Recognition* of Exemption" (emphasis added).

[43] The Blue Book at 405 (emphasis added), See also Animal Protection Inst., Inc., *supra* note 36 (noting that the exhaustion of administrative remedies only required that organizations supply "any *reasonable* information requested by the Service").

[44] Available at www.irs.gov/pub/irs-tege/letter5228.pdf.

[45] NorCal Tea Party Patriots, number 1:2013cv00341, 5/20/13, available at http://dockets.justia.com/docket/ohio/ohsdce/1:2013cv00341/163188/.

[46] True the Vote, Inc., number 1:2013cv00734, 5/21/13, available at http://dockets.justia.com/docket/district-of-columbia/dcdce/1:2013cv00734/160085/.

[47] Linchpins of Liberty, number 1:2013cv00777, 5/29/13, available at http://dockets.justia.com/docket/district-of-columbia/dcdce/1:2013cv00777/160174/.

[48] The discussion of these cases will focus on the *True the Vote* and *Linchpins of Liberty*. While the *NorCal Tea Party* case presents a variety of unique issues and questions that warrant discussion and analysis, such questions are unrelated to the exemption issues involved with the Service's review of tax-exemption applications that are the focus of this article. The *NorCal Tea Party* class action suit does not seek declaratory relief related to its qualification for tax-exempt status and was filed in a court that lacks jurisdictional authority to grant such declaratory relief. As such, it involves issues that are beyond the scope of this article. Additionally, the discussion of the *True the Vote* and *Linchpins of Liberty* cases will be limited to the declaratory and injunctive relief requested in these complaints because the request for monetary relief also is beyond the scope of this article.

[49] 5 U.S.C. section 551 *et seq.*

[50] Section 7421.

[51] 28 U.S.C. Section 2201.

[52] Cited in "American United," Inc., 31 AFTR 2d 73-582, 477 F2d 1169, 73-1 USTC ¶9165 (D.C. Cir., 1973), *rev'd on other grounds* 33 AFTR 2d 74-1289, 416 US 752, 40 L Ed 2d 518, 74-1 USTC ¶9439, 1974-2 CB 401 (1974).

[53] Cammarano, 3 AFTR 2d 697, 358 US 498, 3 L Ed 2d 462, 59-1 USTC ¶9262, 1959-1 CB 666 (1959).

[54] 28 U.S.C. Section 2201.

[55] Section 7421.

[56] 5 U.S.C. Section 702.

[57] Bob Jones University v. Simon, 33 AFTR 2d 74-1279, 416 US 725, 40 L Ed 2d 496, 74-1 USTC ¶9438, 1974-1 CB 354 (1974).

[58] Enochs v. Williams Packing & Navigation Co., 9 AFTR 2d 1594, 370 US 1, 8 L Ed 2d 292, 62-2 USTC ¶9545, 1962-2 CB 349 (1962).

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PAYING FOR THE BEST: EXECUTIVE COMPENSATION FOR SECTION 501(c)(3) PUBLIC CHARITIES

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AUTHOR

Matthew T. Journy, Esq.
Associate
Nonprofit Organizations and Associations
202.344.4589
mtjourny@Venable.com

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PAYING FOR THE BEST: EXECUTIVE COMPENSATION FOR SECTION 501(c)(3) PUBLIC CHARITIES

Executive compensation is one of the most important issues that a public charity must address. Organizations often are pulled in many directions when dealing with executive compensation. Charities need to balance their overall tax-exempt objectives with their need to hire and retain skilled management to accomplish those objectives, their future growth with their financial constraints, and their desire to compensate exceptional service with the public perception of corporate greed. Dealing with executive compensation is a difficult task for all organizations, exempt and taxable alike. For public charities, however, the disclosure requirements and their reliance on goodwill mean executive compensation is not only a difficult issue, it is also a public issue.

The need to address executive compensation has grown significantly over the past few years, as this is an issue that recently has been at the forefront of the Service's attention. The redesign of the Form 990, the extensive discussion of executive compensation in the Interim Report for the College and University Compliance Project, and the Service's rediscovery of Section 4958 all result in a need for charities to evaluate the amount of compensation provided to their executives, assess their risk, and address any potential issues or areas of concern.

In the author's experience, when dealing with executive compensation, charities generally go through three very common and distinct phases—denial, fear, and acceptance.

In the first phase, organization executives simply say that compensation is not a problem for their organization. As such, a major hurdle in this phase tends to be the assumptions and privacy issues of the organization's executives. During this phase, many executives refuse to believe that the amount of their compensation is a significant issue to anyone other than themselves. When it comes to compensation, executives tend to believe two things above all else: (1) they are compensated fairly and, if anything, are under-compensated; and (2) if anyone does care to question their compensation, "it's none of their business." Unlike executives, governing boards do not have such a personal or visceral response to executive compensation; rather, questions from the board tend to focus on risk, both to the organization and to themselves.

During the denial phase, the typical questions asked by organizations include:

- Who cares?
- Does it really matter how much we pay our executives or how we determine executive compensation?
- What are the risks of overcompensation?

Once an organization recognizes that the amount of executive compensation can have serious consequences to the organization's tax-exempt status and could result in significant tax penalties, the organization tends to enter into the fear phase. This phase is often spearheaded by the board of directors. Initially, during this phase, the governing board may view the organization's executives as adversaries in the compensation approval process. Board members may even blame certain executives for placing the organization at risk of revocation and potentially placing the board members at risk of personal liability. During the fear phase, the questions asked by the organization's governing board tend to include:

- How much compensation is reasonable compensation?
- Can we pay executives above the fiftieth percentile?

Eventually, every organization reaches the acceptance phase. This will happen once the organization's executives recognize the need to address the potential issue of overcompensation and the organization's board recognizes that, in order to attract the level of talent necessary to accomplish the its mission, the organization will need to provide reasonable and competitive compensation. Once an organization reaches this point, it is able to rationally analyze its executive compensation and the process used to approve such compensation. The questions then become more appropriately issue-focused, including:

- What can the organization do to protect itself from a finding of excess compensation?
- What are the potential red flags that inform the Service about potential executive compensation issues?

With the Service's recent emphasis on executive compensation and its rediscovery of **Section 4958**, it is important that exempt organizations and their advisors be well aware of the issues relating to executive compensation and the risks of providing excessive compensation, both to the organization and its management.

DENIAL

Many executives consider the amount of their compensation to be a private matter and do not like to discuss or to be questioned about the appropriateness of their salary. When the issue of executive compensation is discussed, executives frequently blow off the issue, saying that no one cares about their compensation and, even if people did care, it is none of their business. This assumption about personal privacy is unfounded and dangerous, however. The list of individuals and entities who care about the types and amount of compensation provided to executives of nonprofit organizations is long. It includes the IRS, state regulators, the media, competing organizations, executives of other exempt organizations, and the organization's own employees. Further, while a particular individual's compensation may be nothing more than a curiosity even to these stakeholders, as a matter of law it is the business of state and federal regulators and of potential donors. Moreover, with the substantial

amount of information that tax-exempt organizations must make available to the public, these interested persons have ample information to satisfy their curiosity, irrespective of whether they have a justifiable need or purpose for obtaining the information. It is this mix of public curiosity and the widespread availability of information about executive compensation that makes the potential risks of excessive compensation so great.

Once an executive acknowledges that people may care about the amount of their compensation, they often fail to recognize the significance of executive compensation. This is largely due to a failure to recognize that, for most organizations, the very premise for the Service's recognition of tax-exempt status is that neither the organization's earnings nor assets inure them to the benefit of a private individual and that the organization's activities do not confer a greater than necessary private benefit. Moreover, many executives of organizations exempt under **Section 501(c)(3)** or **(c)(4)** are almost completely unaware of the substantial penalties that the Code imposes on excessive compensation though **Section 4958**.

Finally, even when they acknowledge that people do care about the amount of their compensation and that it may impact their organizations' exempt status, many executives will perform a quick calculation in their head in which they weigh the value of the benefits that they believe that they provide to the organization against the amount of their compensation. Almost without fail, the executives will determine that, if anything, they are underpaid for the vast number of important services provided to the organization. As such, they quickly dismiss the issue, believing that there is no real risk of overcompensation. This quick calculation often fails to consider all of the risks, however, including loss of exemption and the potential of personal liability for excise taxes should the IRS disagree with their conclusion. Additionally, while many positions relating to executive compensation are defensible, the lack of an appropriate approval process for such compensation may itself lead to a perception of excessive compensation that may result in unwanted public or regulatory scrutiny and perhaps even a proposed adverse determination. Thus, even a fully defensible position may cause an organization to endure significant expense and hardship if the organization's approval process does not sufficiently demonstrate the reasonableness of the amount of executive compensation.

WHO CARES?

As noted above, the list of individuals and organizations that care about the compensation of particular executives is long and the list of reasons why they care is equally long. The first, and probably the most significant, entity on this list is the IRS. Contrary to the belief in privacy held by many executives, executive compensation is the Service's business.

The IRS. In recent years, executive compensation has been a hot topic for all organizations, and charities have not been an exception. The Service's focus on executive compensation has been demonstrated by the information that it seeks from organizations in the Form 990, the Tax-Exempt/Government Entities annual work plans, public statements by IRS officials, publications by the IRS in recent years, and in the actual IRS enforcement efforts, including litigation.

The redesigned Form 990. In 2007, the Service released a redesigned Form 990 with the intention of improving organizational reporting and streamlining IRS enforcement with respect to several important issues. These included executive compensation, governance procedures for approving executive compensation, and the independence of an organization's governing board. Specifically, the

Service added questions to the redesigned Form 990 requesting information that is directly relevant to determining whether the organization is providing reasonable compensation, including:

- *Part VI, "Governance, Management, and Disclosure."* In Part VI a tax-exempt organization must describe the composition of its board of directors, its governance and management structure, and its policies for promoting transparency and accountability to members and beneficiaries. Notwithstanding these requests, the Service has made clear that no particular policy or form of governance is compelled as a matter of law.

- *Schedule J, "Compensation Information."* Organizations are required to provide additional information about officers, directors, and employees who earn more than $150,000 in reportable compensation (as reflected on Forms W-2 or 1099) or $250,000 in total compensation (including nontaxable fringe benefits and expense reimbursements). Affirmative responses to this question on the main body of Form 990 will trigger more detailed reporting requirements in Schedule J. In addition to requiring the organization to break out base compensation, bonus and incentive compensation, other compensation, deferred compensation, certain nontaxable benefits (described below), and compensation reported in prior Forms 990, Schedule J specifically asks whether an organization's compensation approval process takes the steps necessary to establish the rebuttable presumption of reasonableness. Additionally, Schedule J requests information about other benefits that the organization provides to its executives in addition to compensation, including payments for first-class or charter travel, travel for companions, tax indemnification and gross-up payments, discretionary spending accounts, housing allowances and payments for the business use of a personal residence, health or social club dues or fees, and personal services (such as those of a maid, chauffeur, or chef).

- *Schedule L, "Transactions with Interested Persons."* Organizations are also asked whether they have engaged in an excess benefit transaction with an interested person in the past year. If this question is answered affirmatively, the organization must also complete Schedule L. In the current version of Form 990, Schedule L has been structured to incorporate all conflict of interest reporting relating to transactions with interested persons into a single location.

Due to the level of detail and reporting of executive compensation packages in years 2008 and later, substantiating the reasonableness of executive salaries and benefits must be a top priority for all organizations submitting a Form 990, and as every tax-exempt organization knows well, details reported in Form 990 become public information. An organization that pays employees what may be viewed as excessive compensation risks affecting the public perception of the organization as a whole and jeopardizing future fundraising efforts, membership support, and the like.

Public statements by IRS officials, workplans, and publications. On 11/23/10, in a speech to the Practicing Law Institute conference, Lois Lerner, the IRS Director of Exempt Organizations, indicated that the Service was going to once again begin focusing on whether exempt organizations are providing their executives with excessive compensation. This announcement was consistent with anecdotal evidence that practitioners have seen while representing tax-exempt organizations in IRS examinations. Basically, the IRS has rediscovered Section 4958 and has begun using this previously forgotten enforcement tool with a new vigor.

The 11/23/10 announcement about the focus on executive compensation is consistent with other public statements made by IRS officials. For instance, at a Georgetown Law Center conference on Nonprofit Governance on 4/27/11, IRS Area Manager Peter Lorenzetti identified executive compensation as "far and away the most common risk area for nonprofits" and an issue that the Service will "look at on every audit we do."

Additionally, enforcement efforts relating to executive compensation were discussed in the Exempt Organization Implementing Guidelines for fiscal years 2006, 2007, and 2008, and in the IRS TE/GE Fiscal Year 2011 Workplan.

Finally, the Service's focus on executive compensation issues is clearly evinced by the interim report on its College and University Compliance Project ("Interim Report").[1] Published on 5/7/10, the Interim Report summarized the information that the Service received in response to compliance questionnaires sent to more than 400 colleges and universities in October 2008. The Interim Report identified executive compensation as an area of focus moving forward with the Compliance Project. The information in the Interim Report is valuable for all tax-exempt organizations because it provides a roadmap of the issues to be reviewed during future IRS examinations. Two of the most prominent issues discussed in the Interim Report were executive compensation and organization governance.

In reviewing executive compensation and organizational governance, the Interim Report noted that the "questions were principally focused on issues related to excess benefit transaction under section 4958 of the Code."[2] As such, the Service gathered a substantial amount of information about the total amount and type of compensation provided to the officers, directors, trustees, key employees, and highly compensated employees of each surveyed college and university. Additionally, the questions requested information about the compensation approval process used by each organization, including: whether the organization had a written compensation policy, whether the organization used outside consultants to determine the reasonableness of the amount of compensation paid, whether the organization used comparability data to determine the reasonableness of the amount paid to its executives, and whether the organization's compensation approval process was sufficient to establish the rebuttable presumption of reasonableness.

Based on the Service's public and published statements, including the Interim Report, it is clear that executive compensation is a significant issue on which the Service is focused. Thus, it would be wise for organizations to focus their own attention on identifying and addressing potential issues related to executive compensation.

IRS enforcement efforts. All of the information that the Service has publicly disclosed with respect to its review and enforcement activities regarding executive compensation comports with its actual enforcement efforts. As noted by Lois Lerner, the Service has once again started enforcing the provisions of Section 4958.

A quick review of the published rulings by the Service demonstrates that, while the Service published five technical advice memoranda imposing excise taxes under Section 4958 in 2004, it imposed or recommended the imposition of such taxes in only one published TAM or private letter ruling between 2004 and 2011. Additionally, since the Fifth Circuit found that the Service failed to meet its burden in imposing intermediate sanctions in *Caracci,* 98 AFTR 2d 2006-5264, 456 F3d 444, 2006-2 USTC ¶50395 (CA-5, 2006), the Service's enforcement of Section 4958 had been almost nonexistent. Since October 2008, however, the author's

firm has seen 18 cases in which the Service imposed or proposed intermediate sanctions under Section 4958. Additionally, the Service recently litigated a case regarding the imposition of excise taxes under Section 4958 in the United States Tax Court ("Tax Court"). Thus, consistent with its many public statements, the Service's enforcement efforts evince its focus on executive compensation and, in particular, on the enforcement mechanisms of Section 4958.

Others. While the focus of this discussion is on IRS enforcement efforts with respect to executive compensation, to put this issue in its proper perspective, it is important to include a brief discussion on other individuals and entities that may be concerned with the amount of compensation earned by an organization's executives, as well as the motivations for such interest. Those interested include potential donors, competing organizations and interests, the media, and employees.

Potential donors. Due to the economic conditions of recent years, the pool of available donations for charities has dwindled and the competition for funding has increased. Increased competition for more limited donations is making it increasingly important for organizations to use information available to the public, such as the Form 990, to demonstrate that the organization is using its funds to the fullest extent possible to efficiently achieve their exempt missions. This is especially important when trying to attract charitable contributions from potential donors.

Overall, donors are primarily concerned with a charity's exempt mission and a significant concern when making a substantial contribution is how that contribution will be used to accomplish that mission. For many organizations, the list of donors often includes a substantial number of people who take the organization's mission personally because their lives have been affected by the issue that the organization is working to address. Such donors care less about the fairness of the organization's executive compensation than they do about accomplishing the organization's underlying mission. Due to the substantial amount of information disclosed in an organization's Form 990, any potential donor can look at page 10 of a charity's Form 990 and instantly see and compare the portion of an organization's expenses that are comprised of executive compensation with the portion of the organization's total expenses that are used on programs directly related to the organization's mission.

Given the limited pool of charitable donations and the increased competition for them, it is easy for competing organizations that expend a smaller portion of their total expenses on executive compensation to use this information to demonstrate a greater commitment to the accomplishment of the organization's exempt mission, regardless of the veracity of such claims. As such, the provision of excessive compensation, or even high but reasonable compensation, may impact the perception that donors have of the organization and the willingness of such donors to make contributions to a particular charity.

Competing organizations and interests. A recent trend in the world of tax-exempt organizations is for individuals to use information reported in the Form 990 to publicly discredit the tax-exempt status of entities. These attacks tend to focus on competing interests and seek to use media and regulatory attention to change public opinion or even cause the revocation of an organization's tax-exempt status. A recent example of this is a complaint filed with the IRS by Common Cause against the American Legislative Exchange Council (ALEC) in May 2012, in which Common Cause filed a complaint with the Service seeking a review of ALEC's activities. Another example is the Playoff PAC, an organization created for the purpose of eliminating college football's Bowl Championship Series (BCS) and

replacing it with a playoff system (an effort motivated in part by perceived excessive compensation involved in the playoff system). The Playoff PAC example should be considered by all charities that engage in highly politicized or controversial activities and lack adequate compensation approval processes.

The Playoff PAC was able to garner a substantial amount of media exposure by using publicly available information to create the perception that the individual tax-exempt organizations comprising the BCS—the Fiesta Bowl, Sugar Bowl, Orange Bowl, and Rose Bowl—were using the benefits of their status as public charities to engage in prohibited activities such as the provision of excessive compensation. A large part of the Playoff PAC's success appears to be its ability to attract media and public attention to the compensation and compensation practices of the Fiesta Bowl in particular, and the compensation provided to its chief executive officer, John Junker. The perceived abuses, especially those related to executive compensation and extravagant employee benefits, were the subject of multiple media exposes, and were the subject of reports by ESPN, HBO, *Sports Illustrated,* and the *NonProfit Times.* Based, in part, on the efforts of the Playoff PAC and the negative attention it was able to attract to the compensation of the executives of the individual bowl organizations, John Junker was fired and subjected to criminal investigations, and college football's BSC system was recently replaced with a playoff system.

The Playoff PAC example is also indicative of the media attention that compensation issues attract. The success of the Playoff PAC in obtaining its goal of a college football playoff was largely attributable to the public and political pressure that the Playoff PAC was able to impose on the various entities that make up the BCS, such as the individual bowl organizations. Moreover, the general interest in the issues discussed in the media helped focus the public and political attention on the BCS.

As demonstrated by the Playoff PAC example, questions about executive compensation can have a significant impact on an organization and on the individual executives who receive it. Also, compensation that is perceived to be excessive, whether or not it actually rises to the level necessary for enforcement by the Service, is an issue that can generate a lot of attention and potentially lead to significant problems for an organization and its executives.

Employees. Another group that frequently focuses on executive compensation is an organization's employees. The payment of high compensation to an organization's executives may result in complaints or the dissatisfaction of employees who receive substantially lower salaries. While this may be expected and accepted to some degree in any organization, the disparity between executive and staff compensation is often far greater in nonprofit organizations. This can cause issues when an organization pays its chief executive at the 90th percentile while the rest of its staff and management team is paid at the 50th percentile. For the long-term success of the organization, it is important that the organization's employees be qualified and capable because a productive organization is the product of a productive workforce. When an organization clearly favors a single employee or position over others, it may lead to dissatisfaction and high turnover amongst the rest of the employees, which may lead to greater turnover and a less productive organization. Thus, it is important to keep the perceptions of employee compensation in mind when establishing executive compensation.

DOES IT MATTER?

In short, yes. The amount of compensation provided by an exempt organization

to its executives matters. Not only is executive compensation an issue that garners significant attention, it is an issue that can have a significant impact on an organization's qualification for tax-exempt status. Additionally, the payment of excessive compensation can result in substantial financial penalties assessed against the executives who receive it, as well as the board members who approved it.

Exempt status implications of compensation. A charity that provides excessive compensation may jeopardize its tax-exempt status if paying that compensation results in providing a substantial private benefit or causes the organization's net earnings to inure to the benefit of a private individual or shareholder.

Private benefit. Generally, for an organization to qualify as exempt under Section 501(c)(3), it must be both organized and operated exclusively for exempt purposes that provide a public benefit. For purposes of Section 501(c)(3), exempt purposes include religious, charitable, scientific, testing for public safety, literary, or educational purposes. If a substantial amount of an organization's activities are in pursuit of a non-exempt purpose, the organization may not qualify for recognition of tax-exempt status.

Non-exempt purposes include any purpose that serves a private interest rather than a public interest, which is often described as a "private benefit." To be recognized as exempt under Section 501(c)(3),"it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests."[3] It is extremely important for organizations to avoid conferring any prohibited private benefits because, as the Supreme Court has pointed out, the presence of a single non-exempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly exempt purposes.[4]

It is notable that the private benefit doctrine looks only to whether a substantial portion of an organization's activities confer a benefit to private individuals, and not to the relationship that the private beneficiaries have with the organization. As such, the provision of a private benefit can result in the loss of exempt status if the benefit flows to individuals who control the organization's activities or to disinterested third parties. As such, an organization's activities may confer an impermissible private benefit on an individual even if the individual is completely unrelated to the organization. For instance, in *American Campaign Academy,* 92 TC 1053 (1989), the Tax Court determined that, where an organization's activities provided a substantial benefit to the Republican Party and Republican candidates for political office, the organization was not primarily engaged in exempt activities even though the Republican Party was independent of the organization.

In the context of compensation, the Seventh Circuit noted that where an organization was so irresponsibly managed that it paid an unrelated company substantially more than would have been accepted for fundraising services, "it could be argued that [the organization] was in fact being operated to a significant degree for the private benefit of [the fundraiser]."[5] Therefore, to the extent that an organization is providing excessive compensation, it is possible that the organization may be jeopardizing its exemption by conferring a prohibited private benefit even if the compensation is not provided to an individual who controls the organization's operations.

Private inurement. In addition to the prohibition on private benefit, charitable organizations are prohibited from allowing any part of their net earnings to inure them to any private individual or shareholder.[6] Private inurement is similar to private benefit, sharing common and often overlapping elements; in fact, the Tax Court has noted that "the private inurement may be arguably subsumed within

the private benefit analysis."[7] However, private inurement is more limited in the scope of the beneficiaries' relationship to the organization and with respect to the types of benefits resulting in inurement. As private inurement is subsumed by, and a more limited application of, the private benefit doctrine, the Service has correctly taken the position that "all inurement is private benefit, but not all private benefit is inurement."[8]

The private inurement doctrine is derived from Section 501(c)(3), which provides that, to be recognized as exempt, "no part of the net earnings" of the organization may inure to the benefit of "any private shareholder or individual." The term "private shareholder or individual" refers to persons having a personal and private interest in the activities of the organization.[9] More generally, the private benefit doctrine prohibits a charity from siphoning "its earnings to its founder, or the members of its board, or their families, or anyone else fairly to be described as an insider, that is, as the equivalent of an owner or manager."[10] Thus, unlike the private benefit doctrine, private inurement is applicable only to transactions between a tax-exempt organization and an "insider" (i.e., someone having a close relationship with and/or the ability to exert influence over the tax-exempt organization).

Another limitation on the application of the private inurement doctrine is the type of benefits that may result in private inurement. As discussed above, the private benefit doctrine looks to whether an organization's activities confer a substantial benefit on private individuals. As such, the nature of the benefit of the organization's activities are considered in determining whether an organization has conferred an impermissible private benefit, and whether it is possible for an organization's activities to confer a substantial benefit on an unrelated party even where no pecuniary benefit is conferred, as was the case in *American Campaign Academy*. However, because the Code prohibits the inurement of an organization's "net earnings," there generally needs to be a monetary aspect to benefits conferred to invoke the private inurement doctrine. More general benefits such as a larger pool of informed political campaign managers to serve a single political party will not result in inurement.

Two common situations that may result in private inurement are, first, an insider's exercising control over the net earnings of an organization "to make ready personal use of the corporate earnings"[11] and, second, an insider's receiving a return benefit from an organization that exceeds that value of the goods or services that the insider provided to the organization. In the context of employee compensation, the first situation is most often seen with respect to inadequate controls over expense reimbursements. Where the organization pays or reimburses an insider for personal expenses, courts have ruled that the organization's net earnings inured to the benefit because the insider "was free to make personal use of such corporate funds for himself and his family when, if, and as he chose to do so."[12] Moreover, in these situations, courts have determined the existence of private inurement through the personal use of corporate earnings even where the combined total value of the benefit and the total amount of compensation would not have been an unreasonable or excessive amount of compensation.[13]

The other type of situation that may give rise to private inurement is directly related to overcompensation. For purposes of private inurement, the term "net earnings" has been interpreted to include all expenses other than those ordinary and necessary for the operation of an organization.[14] As such, courts have repeatedly held that salaries that are "excessive salaries do result in inurement."[15] Thus, executive compensation may constitute private inurement if the amount of the compensation is greater than fair market value and the

payment of such compensation results in an unreasonable return benefit to the executive.

Personal liability of officers and directors resulting from excessive compensation. In addition to the private benefit and private inurement prohibitions, which may result in the revocation of an organization's tax-exempt status, the Code seeks to protect an exempt organization's assets from being used for the benefit of the individuals in control by imposing an excise tax on certain individuals who receive excessive benefits. Section 4958 imposes excise taxes (referred to commonly as the "intermediate sanctions") against certain individuals and private entities that receive better than fair market value in transactions with qualifying organizations.[16] Additionally, Section 4958 imposes an excise tax on all organization managers who knowingly participate in the transaction that resulted in the provision of an excessive benefit.

The focus of the Code's intermediate sanctions provisions are very similar to its proscription on private inurement—a transaction that provides excessive benefit to an individual or an entity that is closely connected with and/or has the ability to exert substantial influence over the tax-exempt organization. However, an important distinction between the two doctrines concerns the type of sanctions that are allowed. Under the private inurement provisions, only the tax-exempt organization may be penalized and the sole penalty available is the revocation of the organization's tax-exempt status. By contrast, the intermediate sanctions provisions impose penalties short of revocation in the form of excise taxes on the individual or entity that benefited from the better-than-fair-market-value transaction, as well as on the individual exempt organization managers who knowingly approve such "excess benefit transactions." It is important to understand that Section 4958 does not prohibit organizations from paying *any* compensation to individuals who control the organization or from entering into any transactions with such individuals. Rather, it simply penalizes individuals who enter into and approve "excess benefit transactions."

Generally, an excess benefit transaction is defined to include "any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person, and the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing the benefit."[17] As such, Section 4958 applies only to transactions in which (1) an applicable tax-exempt organization provides a benefit (2) to a disqualified person, either directly or indirectly;[18] and (3) the value of the benefit received from the applicable tax-exempt organization by the disqualified person exceeds the value of the consideration provided to the organization.[19] Each of these elements is discussed in detail below.

Applicable tax-exempt organization. For a benefit to result in an excess benefit transaction, it must be provided by an applicable tax-exempt organization. For purposes of Section 4958, "applicable tax-exempt organization" generally "includes any organization that was described in section 501(c)(3) or (4) and was exempt from tax under section 501(a) at any time during a five-year period ending on the date of an excess benefit transaction."[20] However, certain organizations such as private foundations, governmental units, and exempt organizations whose income is excluded from gross income under Section 115 are excepted from the definition of an applicable tax-exempt organization.[21]

Therefore, while executive compensation remains a significant issue for private foundations and organizations exempt under other provisions of Section 501(a), the provision of excessive compensation by these organizations will not result in

the imposition of Section 4958 intermediate sanctions.

Disqualified persons generally. In addition to requiring a benefit from an applicable tax-exempt organization, that benefit must be conferred on a disqualified person, either directly or indirectly, to result in an excess benefit. Generally, the term "disqualified person" is defined to include individuals in a position to exercise substantial influence over the affairs of an organization at any point during the five-year period ending on the date of the transaction, and their family members.[22]

Disqualified persons—Substantial influence. In determining whether a person has substantial influence, the Service looks to the individual's position within the organization, his or her responsibilities, and the facts and circumstances relating to his or her employment. Additionally, the regulations expressly deem certain individuals not to have substantial influence.

The regulations set out four categories of individuals who are deemed to have a substantial influence over the affairs of an organization due to their position within the organization:

- *Voting members of the organization's governing body.* Any person who serves on the organization's governing body, and is entitled to vote on any matter over which the governing body has authority, has substantial influence over the affairs of an organization.[23]

- *Presidents, chief executive officers, and chief operating officers.* Any person, regardless of title, who has the ultimate responsibility for implementing the decisions of the governing body is a disqualified person. If the authority is divided among two or more people, each person with such authority is deemed to have substantial influence.[24]

- *Treasurers and chief financial officers.* Any person, regardless of title, who has the ultimate authority for managing an organization's finances is deemed to have substantial influence.[25]

- *People with material financial interests in a provider-sponsored organization.* This category is specific to hospitals. If a hospital participates in a provider-sponsored organization, any person with a material financial interest in the provider-sponsored organization has substantial influence with respect to the hospital.[26]

Aside from the general categories of individuals deemed to have substantial influence, the most important thing to take from the definitions of these categories is that a person does not have to have a particular title in the organization to be deemed to have substantial influence. Rather, the regulations look to an individual's responsibilities within the organization. As such, organizations cannot avoid the impact of Section 4958 through the use of creative titles.

As individuals with substantial influence, each of these groups of individuals are considered disqualified persons and may be subject to intermediate sanctions. Additionally, the approval of excessive compensation to any of these individuals may result in excise taxes imposed on a charity's board members who approve the payment of such compensation.

The scope of individuals who have substantial influence over an organization is not limited to the organization's management or even to people actually employed by an organization. The regulations provide multiple circumstances in

which an individual, regardless of his or her position within an organization, may be deemed to be a disqualified person based on all relevant facts and circumstances.[27] Facts and circumstances that are indicative of substantial control include the following:

- The person is the founder.[28]
- The person is a substantial contributor.[29]
- The person's compensation is primarily based on the organization's revenue or the revenue of a particular function of the organization that is controlled by the person.[30]
- The person has or shares the authority to control a substantial portion of the organization's capital expenditures, operating budget, or employee compensation.[31]
- The person manages a discrete segment or activity of the organization that represents a substantial portion of the organization's overall activities.[32]
- The person owns a controlling interest in a business that is itself a disqualified person.[33]

Based on this list, it is important to recognize that certain individuals, even those seemingly unrelated, may be disqualified persons.

This is frequently an issue for third-party management companies and fundraising organizations that are hired as independent contractors. Independent contractors hired to manage an organization's day-to-day or fundraising activities usually control a substantial portion of the organization's overall activities. Also, organizations that hire independent contractors to provide these services often are cost-conscious and prefer to pay such contractors on the basis of the organization's net revenue, believing that compensation that is a direct result of successful performance is necessarily reasonable. However, based on the facts and circumstances, such independent contractors may be deemed to be disqualified persons because of (1) the substantial control that the contractors exert over a substantial portion of the organization's activities and (2) the fact that the contractors' compensation is based on the organization's revenue or on the organization's fundraising revenue.

In addition to facts that are indicative of substantial influence, the regulations also list facts that indicate the absence of substantial influence for purposes of determining whether an individual is a disqualified person. Facts indicating a lack of substantial influence include the following:

- The person has taken a vow of poverty.[34]
- The person is an independent contractor whose only economic benefit is customary fees for advice rendered.[35]
- The person's direct supervisor is not a disqualified person.[36]
- The person does not participate in management decisions affecting the entire organization.[37]

Based on its consideration of all of these facts, the Service will determine whether the person is a disqualified person.

While it is useful for organizations to understand the facts-and-circumstances

test, this is something that the author's firm has rarely seen the Service use to determine whether an individual is a disqualified person for purposes of Section 4958. In most situations, it can be difficult for the Service to demonstrate substantial influence based on the facts and circumstances. As such, to the extent that these arrangements appear to be reasonable, compensation for such people presents significantly less risk than compensation to individuals who are disqualified persons due to their position within the organization.

If an individual is not a disqualified person because of his or her position within an organization,[38] or due to a material financial interest in a provider-sponsored organization, then—irrespective of the facts or circumstances of employment—an individual who is not a "highly compensated employee" as defined by Section 414(q)(1)(B)(i) is deemed not have substantial influence for purposes of Section 4958.[39] Section 414(q)(1)(B)(i) defines the term "highly compensated employee" to include employees with compensation in excess of a defined amount of compensation that is adjusted for cost of living increases. Therefore, in 2012, unless a person is a disqualified person due to his or her position within an organization, that person will not be deemed to have substantial influence over an organization regardless of the surrounding facts or circumstances of his or her employment if that person earns less than $115,000.[40]

As the individual will not be considered to have substantial influence over the organization, that person will not be subject to intermediate sanctions under Section 4958 regardless of the reasonableness of his or her salary.

Disqualified persons—Family members. Family members of individuals who exert substantial influence are also disqualified persons for purposes of Section 4958. The regulations limit individuals considered to be family members to a disqualified person's spouse; brothers and sisters (by whole or half-blood); spouses of brothers or sisters; ancestors; children (including legally adopted children); grandchildren; great-grandchildren; and spouses of children, grandchildren, and great-grandchildren.[41] Therefore, in addition to concerning itself with reasonableness of the compensation of an organization's management, a governing board must also consider the reasonableness of compensation provided to the family members of those individuals who are employed by the organization.

Excessive benefit. Finally, the most important element of an excess benefit transaction is the existence of the excessive benefit. As the name "excess benefit transaction" implies, without an excessive benefit, there is no issue under Section 4958.

An excess benefit is the amount by which a benefit received by a disqualified person exceeds the value of the consideration provided by the disqualified person to the organization.[42] As such, to determine whether there is an excess benefit transaction, the Service must determine the value of the benefit received by the disqualified person, the value of the consideration provided by the disqualified person to the organization (such as the value of his or her services), and the amount by which the consideration provided by the charity exceeds the value of the consideration received by the disqualified person.

WHAT ARE THE RISKS?

Even after an executive recognizes that people care about his or her compensation and that the amount of compensation does matter, many executives believe this to be an academic question without any real risk. As previously mentioned, however, this belief is incorrect. The risks associated with

overcompensation are significant, and they are borne by both the organization and by the individuals in control of the organization's activities.

Risks borne by the organization. As discussed above, if a tax-exempt organization is found to be in violation of the private inurement proscription, the Service has the power to revoke the organization's tax-exempt status. As revocation is the only penalty for engaging in activities that provide a substantial private benefit, the entire risk of this issue rests with the organization, not management.

It is also important to understand the scope of the risk with respect to inurement and private benefit. If an organization's activities confer a private benefit, the conferring of such a benefit will be fatal to the organization's exempt status only to the extent that the Service determines that the private benefit is substantial in light of the organization's total operations.[43] As such, in *American Campaign Academy,* the Service did not revoke the organization's exempt status because the Republican Party received *some* benefit from the organization due to the qualified campaign managers educated by the organization. Rather, the organization's exempt status was revoked because the organization's graduates "served on campaigns of candidates who were predominantly affiliated with the Republican party"[44] and "the placement of 85 of petitioner's graduates in the campaigns of 98 Republican Senatorial and Congressional candidates conferred a benefit on those candidates."[45] Thus, the substantiality and purpose of the benefit, not its existence, caused the revocation.

Unlike the private benefit doctrine, the prohibition against private inurement is absolute. As such, for purposes of applying inurement, the Service has taken the position that "any taking of the profits (net earnings) is fatal to exemption; the concept does not even go so far as looking at the quality of the organization's charitable activities."[46] Moreover, in applying the private inurement doctrine, the courts have expressly refused to consider whether the total amount that inured to an individual would have been reasonable if paid as compensation. [47] Therefore, the payment of excessive compensation to an organization's managers, or the provision of substantial benefits in addition to compensation, presents significant risks to an organization's exempt status, even when the provision of such benefits is isolated and small in amount.

Risks borne by management and the governing body. In addition to the risks that excessive compensation creates for tax-exempt organizations, the approval and payment of excessive compensation also create a substantial amount of risk of personal liability for individuals who receive excessive benefits and the organization managers who approve the payment or otherwise participate in excess benefit transactions.

Taxes on disqualified persons who receive excess benefits. As discussed above, Section 4958 imposes excise taxes on disqualified persons who receive an excessive benefit from an applicable tax-exempt organization. If the Service determines that a disqualified person received an excessive benefit, under the "initial tax" imposed by Section 4958(a)(1), the Service may impose an excise tax of up to 25% of the amount of excessive benefit on the disqualified person. Additionally, the disqualified person is required to "correct" the excess benefit transaction by "undoing the excess benefit to the extent possible, and taking any additional measures necessary to place the organization in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards."[48] Finally, if more than one person is liable for the tax imposed on an excess benefit transaction, each person is jointly and severally liable for the amount of the tax owed.[49] Therefore, under Section 4958(a)(1), a disqualified person could be liable for an amount equal to 125% of

the amount of an excessive benefit received from an applicable tax-exempt organization.

In addition to the initial tax, Section 4958(b) imposes an "additional tax" on disqualified persons who fail to correct the excess benefit transaction before the Service issues a notice of deficiency regarding the excess benefit. The additional tax imposed by Section 4958(b) is equal to 200% of the portion of the uncorrected amount of the excess benefit transaction.[50] Therefore, if a disqualified person receives an excessive benefit and does not timely correct the excess benefit transaction, the person may be liable for up to 225% of the excessive amount of the benefit.

Under this section of the Code, if an organization's chief executive officer received $200,000 in total compensation and the Service determines that the reasonable amount of compensation was $100,000, the Service could assess intermediate sanctions against the individual. Under these facts, if the CEO corrects the excess benefit, then he or she will have received $200,000 in total compensation and would have been required to pay an excise tax to the IRS of $25,000 while returning $100,000 to the organization. If the CEO did not correct the excess benefit described above, he or she would have received $200,000 in total compensation and would be liable for $225,000 in excise taxes under Section 4958. Thus, it is clear that, under Section 4958, the risks of excessive compensation on those receiving the compensation are significant.

Taxes imposed on participating organization managers. In addition to imposing taxes on disqualified persons who receive excessive benefits, Section 4958(a)(2) "imposes a tax equal to 10 percent of the excess benefit on the participation of any organization manager who knowingly participated in the excess benefit transaction."[51] For purposes of this provision, an "organization manager" generally includes "any officer, director, or trustee of such organization, or any individual having powers or responsibilities similar to those of officers, directors, or trustees of the organization, regardless of title."[52] "Participation" includes both active participation, such as voting in favor of the transaction, and passive participation, such as silence or inaction.[53] Finally, "knowing" requires that the organization manager (1) has knowledge that the fact of the transaction could cause the transaction to be an excess benefit transaction, (2) is aware of the law prohibiting excess benefit transactions, and (3) is aware that the transaction is an excess benefit transaction or fails to make an attempt to ascertain whether the transaction is an excess benefit transaction.[54]

If these conditions are met, the payment of excessive compensation could result in the assessment of an excise tax on the organization managers as well as the individual who received the excess benefit. Additionally, because of the broad definition of the term "participation," an individual who receives an excessive benefit also "participated" in the transaction. As such, the recipient of the excessive benefit may be liable for the 10% excise tax on organization managers in addition to being liable for the taxes imposed by Sections 4958(a)(1) and 4958(b).

FEAR

Once the risks are explained, many organizations panic. This is especially true of three types of organizations—those that have been pushing the envelope with respect to compensation, those with a passive board that has generally complied with the every recommendation made by management, and those that have been controlled by members of a single family. While panicking, an organization's board will want definitive answers and may take drastic measures to correct any

perceived issues. At this point, boards will want to know: what is reasonable compensation; what does the IRS look to in determining whether compensation is reasonable; and whether the organization needs to remove all board members who are related, through family or business, to officers or other board members. It is also common at this point for board members to ask to resign from the board based on concerns about personal liability.

HOW MUCH IS REASONABLE COMPENSATION?

Unfortunately, there is no single or easy answer to this question. Reasonable compensation is based on the facts and the circumstances of each employment situation. In determining the precise amount of reasonable compensation, one must consider a multitude of factors about the organization, its activities, and the individual employee being compensated. In some situations, an organization's president may be overcompensated while receiving an annual salary of $20,000 at the 70th percentile. In other situations, an individual may be reasonably compensated with an annual salary of $800,000 at the 80th percentile. As a result, it is impossible to define what reasonable compensation is; it is only possible to explain what the Service looks to in determining whether a compensation amount is reasonable.

Property transactions. For property transactions, the regulations define fair market value as "the price at which property or the right to use property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy, sell or transfer property or the right to use property, and both having reasonable knowledge of all relevant facts."[55] While generally applying the definition of fair market value used in the regulations, courts have noted that the "willing buyer" and "willing seller" are hypothetical individuals, and that the "hypothetical willing buyer and seller are presumed to be dedicated to achieving the maximum economic advantage."[56] Moreover, when determining fair market value, "the hypothetical sale should not be construed in a vacuum isolated from the actual facts that affect the value."[57] Rather, "the valuation method must take into account, and correspond to," the attributes of the transaction being valued.[58]

Reasonable compensation. In determining whether an amount of compensation is reasonable, the Service must first determine the value of the benefit. With respect to compensation for services, the regulations provide that, with the exception of certain specified benefits, the amount of compensation paid to a disqualified person includes "all forms of cash and noncash compensation"[59] and "all other compensatory benefits, whether or not included in gross income for income tax purposes."[60] The regulations provide that compensation for purposes of Section 4958 does not include nontaxable fringe benefits, expense reimbursement payments made according to an accountable plan, or de minimus fringe benefits.[61] Thus, the scope of compensation for purposes of Section 4958 goes well beyond the scope of compensation for purposes of federal income taxes.

While the regulations broaden the type and amount of compensation subject to Section 4958, they narrow the definition of services provided in exchange for such compensation, stating that a taxable "economic benefit is not treated as consideration for the performance of services unless the organization providing the benefit clearly indicates its intent to treat the benefit as compensation when the benefit is paid."[62] Organizations are not required to demonstrate such intent for non-taxable benefits, such as employer-provided health benefits, contributions to qualified pensions, employer-provided benefits under a Section 127 education assistance program, or employer-provided benefits under a

Section 137 adoption assistance program.[63]

For purposes of the contemporaneous demonstration of intent to treat certain benefits as compensation, the regulations require that an organization demonstrates its intent (1) by reporting the value of the benefit as taxable income on the individual's Form W-2;[64] (2) by reporting the benefit as compensation on the organization's Form 990;[65] (3) by including the amount in a written employment contract;[66] (4) by including the amount in a written document demonstrating that an authorized body intended an amount to be paid as compensation, i.e., board meeting minutes;[67] or (5) through written evidence demonstrating the organization's belief that the benefit was not taxable.[68] In addition to these methods, if an employee reports an amount as wages on his or her individual income tax return, Form 1040, the amount will be characterized as compensation.

Once it determines the total amount of the benefit received by the disqualified person, the Service will compare the amount that the organization paid to the value of the services to determine whether there was an excess. For purposes of this analysis, the "value of services" is "the amount that would ordinarily be paid for like services by like enterprises."[69] Unfortunately, this is not very clear and there is not much additional guidance on this issue. In the 2003 continuing professional education program, however, the Service noted that in evaluating the reasonableness of compensation, it will consider the following:

- The amount of compensation paid by similarly situated organizations, both taxable and exempt, for functionally comparable positions.
- The availability of similar services in the geographic area of the applicable exempt organization.
- Current compensation surveys.
- Actual written offers from competing organizations.[70]

CAN EXECUTIVE COMPENSATION EXCEED THE 50TH PERCENTILE?

Yes, executive compensation can exceed the 50th percentile. As the reasonableness of executive compensation depends on the facts and circumstances of each situation, the same amount of compensation may not be appropriate for two seemingly similar positions. As such, organizations should not strive to pay amounts identical to what is paid by other organizations. Rather, organizations should use the information provided by other organizations to determine the appropriate amount of compensation for individuals with similar responsibilities within their organization. Moreover, the regulations pertaining to the rebuttable presumption discussed below recognize that there may be situations in which an organization may intentionally decide to provide compensation that is either above or below the range of reasonableness demonstrated by the comparability data and, in such situations, the regulations merely require the organization to "record the basis for its determination."[71] Thus, it is not necessary for every organization to pay every executive at the 50th percentile; in fact, blindly paying at a particular percentile may lead to inappropriately high or low levels of compensation.

ACCEPTANCE

Once the organization has acknowledged and accepted that it must pay

compensation to its officers and employees, and that there are risks associated with the overcompensation of such individuals, the organization will start to be productive in its assessment of risks and its efforts to address such risks.

HOW TO PROTECT THE ORGANIZATION AND OFFICIALS?

The best way for an organization to protect itself from the risks of excessive compensation is to: (1) establish the rebuttable presumption of reasonableness, (2) establish compensation and conflicts of interest policies that ensure independence on all decisions related to compensation, (3) obtain the advice of experts where prudent, and (4) avoid raising red flags through IRS filings.

Establish the rebuttable presumption of reasonableness. The regulations establishing the rebuttable presumption of reasonableness set forth a procedure that allows exempt organization directors to evaluate compensation levels paid to insiders. [72] The benefit of following the procedure is that doing so creates a "rebuttable presumption" that the payment amounts are reasonable. In short, all of the following three steps are necessary to establish a presumption that the amount of compensation is reasonable:

(1) The compensation arrangement is approved in advance by an authorized body of the organization, and that body is composed entirely of individuals who do not have a conflict of interest with respect to the compensation arrangement.

(2) The authorized body obtained and relied upon appropriate data as to comparability (such as valid salary surveys) prior to making its determination.

(3) The authorized body adequately documented the basis for its determination concurrently with making that determination.

The IRS still may "rebut" the presumption, but only if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body. It should also be noted that under the regulations, an organization's failure to establish the rebuttable presumption of reasonableness should not create a presumption about the existence of an excess benefit.[73]

For the first of the above steps, the "authorized body" may be the members of the board of directors of an organization or a committee established by the board. Of course, individuals who are having their compensation reviewed may not be members of such a body, nor may relatives of such individuals or others who may have a conflict of interest with regard to the determination.

For the second of the above steps, "adequate comparability data" may include a comparison with the compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; a review of the availability of similar services or expertise in the geographic area of the applicable tax-exempt organization; and a review of current compensation surveys compiled by independent firms.

Finally, for a decision to be documented adequately, the written or electronic records of the authorized body must note all of the following:[74]

(1) The terms of the transaction that was approved and the date it was approved.

(2) The members of the authorized body who were present during debate on the

transaction that was approved and those who voted on it.

(3) The comparability data obtained and relied upon by the authorized body and how the data was obtained.

(4) Any actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction.

(5) If the authorized body determines that reasonable compensation for a specific arrangement or fair market value in a specific property transfer is higher or lower than the range of comparability data obtained, the authorized body must record the basis for its determination.

(6) For a decision to be documented concurrently, records must be prepared before the later of the next meeting of the authorized body or 60 days after the final action or actions of the authorized body are taken. Records must be reviewed and approved by the authorized body as reasonable, accurate, and complete within a reasonable time thereafter.

Institute policies ensuring independence. Two of the most important policies that can be used to protect an organization against the possibility of excessive compensation are a conflict of interest policy and a compensation policy that establishes the rebuttable presumption of reasonableness. These policies will help in three very important ways. First, the implementation of these policies will increase the independence and thoroughness of the compensation approval process, which by its nature will decrease the probability that an organization will provide unreasonably excessive compensation. Second, as discussed in greater detail below, implementation of the policies will be reported on the organization's Form 990, which leads to the perception of a compliant organization. Third, the use of such policies will result in the rebuttable presumption of reasonableness, which will itself lead to several substantial benefits relating to the perceived reasonableness of executive compensation.

Obtain the advice of experts. Obtaining the opinion and advice of an independent expert in the compensation approval process is a valuable tool to protect the organization from paying unreasonably high compensation. Additionally, the regulations provide that where a governing body obtains and relies on the reasoned written opinion of a professional with respect to the elements of the transaction, the governing body will not be deemed to have knowingly participated in an excess benefit transaction, even if the amount of compensation is subsequently determined to be excessive for purposes of Section 4958.[75] As such, the reliance on the well-reasoned advice of an organization's legal counsel, an accounting firm with expertise regarding relevant tax law matters, or an independent compensation valuation expert can be used to protect the governing body and other organization managers from excise taxes imposed by Section 4958(a)(2).

Avoid raising red flags in IRS filings. The easiest way for the Service to find organizations that provide unreasonably excessive compensation is by reviewing the information sent to the IRS every year on Form 990. As previously discussed, Form 990 requests a substantial amount of information related to executive compensation, including: "did the organization engage in an excess benefit with a disqualified person"[76] and did the organization "follow the rebuttable presumption procedure" with respect to executive compensation.[77]

With questions that are specific to whether an organization provided excessive benefits, it is important for organizations to understand what is reported in their

annual Forms 990, and tailor their compensation practices to the information reported. For instance, in Part V, Form 990 requests a substantial amount of information about governance procedures, including whether an organization has implemented policies not required by the Code. While these policies are not required, the absence of these policies will not go unnoticed, especially for organizations that pay significantly higher amounts of compensation than their peers.

In short, one way that an organization can protect itself is by understanding the Form 990, and establishing a compensation policy that is responsive to the compensation information reported on the form.

Finally, if an organization suspects that it may have engaged in one or more excess benefit transactions in the past, it should consult with legal counsel expert in the area before simply conceding that fact through checking the relevant box on the Form 990. There are multiple ways to deal with problems like this.

OTHER ISSUES

When dealing with excess benefit transactions, the Service's enforcement of the **Section 4958** is as important as, if not more important than, the content of the law itself. About six years ago, an organization was under examination for periods during which its highest executives had taken about $50 million from the organization through transactions with corporations controlled by the executives. However, the Service, still hurting from its loss in the *Caracci* case, did not even raise the issue of intermediate sanctions, choosing instead to pursue revocation on the basis of private inurement and public benefit. In that era, just after the *Caracci* decision, excessive compensation was an exemption issue only and intermediate sanctions were no more than an afterthought. Today, however, intermediate sanctions are an issue explored in every examination with potential compensation issues. Unlike six years ago, when the Service ignored a potential $50 million issue, within the last two years the Service has raised automatic excess benefit transaction issues for total proposed assessments of less than $750.

IRS ENFORCEMENT OF SECTION 4958

Based on the recent experience of the author's firm, the Service does not play fair when it comes to enforcement of **Section 4958**. The Service's current enforcement efforts appear to have three purposes: (1) assessing an extremely high excise tax for the purpose of achieving a quick settlement, (2) making inappropriate inferences from organizations that fail to establish the rebuttable presumption of reasonableness, and (3) asserting very small penalties under the automatic excess benefit provisions of the Code.

Unsupported excessive penalties. To demonstrate that a transaction resulted in an excessive benefit to a disqualified person, the Service must demonstrate that the benefit received by the disqualified person exceeded the fair market value of the consideration provided to the applicable tax-exempt organization. It is therefore not sufficient for the Service merely to assert the existence of an excessive benefit. Rather, it must demonstrate the existence of a benefit that exceeded the fair market value of all consideration provided, including consideration provided in years other than those in which the benefit was conferred.

At least one court has ruled that it is arbitrary and erroneous for the Service to

impose a Section 4958 excise tax based on a valuation analysis that is provided by an individual who lacks sufficient expertise and who based his valuation on incomparable data.[78] In the *Caracci* decision, the court denied the imposition of intermediate sanctions where the Service's position was based on a valuation resulting from "a brief, intermediate internal analysis." Further, the court noted that where the Service took a position based on a valuation that was clearly erroneous and:

> "so incongruous as to call [the Commissioner's] motivation into question...[i]t can only be seen as one aimed at achieving maximum revenue at any cost...seeking to gain leverage against the taxpayer in the hope of garnering a split-the-difference settlement—or, failing that, then a compromise judgment—somewhere between the value returned by the taxpayer...and the unsupportedly excessive value eventually proposed by the Commissioner."[79]

Therefore, when asserting an excise tax under Section 4958, not only is it necessary for the Service to provide a valuation demonstrating the excessive value of the benefit received, it is necessary for the Service to demonstrate the accuracy and reasonableness of it valuation. However, as in *Caracci*, the Service's current enforcement efforts appear to be focused on intimidation and not reasonable efforts to determine the value of all of the consideration exchanged between the parties.

As an example, in a recent Tax Court case handled by the author's firm regarding intermediate sanctions, the Service determined that a disqualified person's sale of property to a public charity conferred a benefit of $0 on the charity because, in the Service's unsupported opinion, the charity could have obtained the property from the disqualified person without charge.[80] More significant than the unsupported nature of the Service's position is the fact that, during discovery, the taxpayer learned that, prior to issuing the notice of deficiency, an IRS valuation engineer actually analyzed the transaction and determined that the value of the consideration received by the charity exceeded the amount of consideration provided to the disqualified person. As such, in this case, the Service disregarded the reasoned opinion of its own valuation expert in determining an excise tax in excess of $1 million.

In situations such as the *Ossenfort* case,[81] the Service's determination, as unreasonable as it may seem, puts the taxpayer in a precarious situation. First, the Tax Court rules favor the IRS. Second, the expense of litigation, viewed in conjunction with the possibility of having to pay even a portion of the proposed penalty upon losing the case in court, makes it very difficult to justify continued litigation by compounding the potential harm that could result. Thus, in the *Ossenfort* case handled by the author's firm, even though the Service conceded the entire amount of tax provided by the notice of deficiency and agreed that the total amount of tax owed by the taxpayer was $0, the Service was able to punish the petitioner by waiting to settle the case until just over a month before the trial.

The substantial delay in conceding the case essentially allowed the Service to punish the taxpayer by forcing her to endure to the stress, public embarrassment, and expense of litigation for almost two years. As a result, throughout the litigation of an issue for which the Service fully conceded, the author's client was forced to deal the with self-doubt and public pressures resulting from the litigation. These pressures, in addition to the potential penalty in excess of $1 million, caused the taxpayer to consider the giving up the fight several times before the Service finally conceded the case. Fortunately for the author's client, she was committed to her cause and saw the case through until

its conclusion, vindicating her perseverance and efforts.

Inappropriate inferences regarding the rebuttable presumption. As previously mentioned, the regulations provide that the fact that a transaction between an applicable tax-exempt organization and a disqualified person is not subject to the presumption of reasonableness does not create any inference that the transaction is an excess benefit transaction.[82] However, this is not the case in the Service's current enforcement of Section 4958. In the Tax Court, the Service has effectively taken the position that the taxpayer's failure to contemporaneously establish the value of the consideration provided to the charitable organization is in itself evidence of an excess benefit transaction. Additionally, in other situations, the Service has used the lack of the presumption of reasonableness to base its position on weak and easily distinguishable comparability data.

In litigation, the Service's position is that because the notice of deficiency is presumed to be correct, it is the taxpayer's obligation to prove the value of the consideration that the tax-exempt organization received in the transaction. As such, the Service has taken the position that it is not required to produce anything aside from its theory in order to sustain its position. In fact, the Service has said in some instances that it does not even intend to use a valuation expert to support its position at trial.

In other situations, the Service has used the lack of the rebuttable presumption to base its position on weak and distinguishable evidence. As noted above, under the regulations, to rebut the presumption of reasonableness the Service must develop "sufficient contrary evidence to rebut the probative value of the comparability relied upon by the authorized body."[83] Where there is no comparability data to rebut, however, the Service has based its position on a selective and incomparable set of data. For example, on one occasion, in support of its determination of intermediate sanctions, the Service compared the compensation of the chief executive officer of an organization located in Los Angeles to organizations located in places such as Kokomo, Indiana; Bethany, Oklahoma; Sioux City, Iowa; and South Portland, Maine. In fact, in the Service's study, of the 13 organizations listed in the Service's comparability report, only three organizations were located in cities with populations greater than 500,000. Additionally, one of the 13 organizations included in the Service's comparability report did not report any information regarding the compensation of its chief executive officer, whom the Service incorrectly included in the report as a full-time employee who received compensation of $0. Therefore, because the Service was not required to develop sufficient information to rebut information used by the taxpayer, it developed a flawed report it could use to support the position that it wanted to take.

Automatic excess benefit transactions. Another way in which the Service is able to force taxpayers into quick and unchallenged assessments is by characterizing a payment as an automatic excess benefit.

The regulations provide that if "an organization fails to provide this contemporaneous substantiation, any services provided by the disqualified person will not be treated as provided in consideration for the economic benefit for purposes of determining the reasonableness of the transaction."[84] Thus, any benefit provided to a disqualified person will be an automatic excess benefit subject to the correction provisions of Section 4958 unless the organization demonstrates its intent to provide the benefit in exchange for services through contemporaneous documentation.

Automatic excess benefit transactions, especially those resulting from

reimbursement of business expenses, tend to be the result of poor recordkeeping and not an intentional effort to gain substantial excessive benefits. As such, these are most often found in small organizations that lack the sophistication or administrative processes of larger, more established organizations. Also, unlike $50 million excesses, the lower amounts of unsupported reimbursements are unlikely to be challenged because it is simply not cost-effective to pay for outside counsel to contest a $700 penalty. Thus, through the enforcement of the automatic excess benefit transaction rules, the Service is able to assess penalties under **Section 4958** without challenge.

RECOMMENDATIONS

In light of the substantial scrutiny executive compensation attracts and the Service's current enforcement efforts, it is important that charities take certain precautions to protect themselves against the perception or possibility that they are providing excessive executive compensation. One of the most important things organizations can do to protect themselves is to create and implement a compensation approval policy that establishes the rebuttable presumption of reasonableness. A second way in which organizations can protect themselves, and especially their boards of directors, is to obtain advice regarding the reasonableness of compensation. Finally, for transactions that involve insiders of the organization, but are not necessarily compensation arrangements, the implementation and use of a thorough conflict of interest policy can help avoid excess benefit transactions. Implementation of these recommendations can protect an organization and its managers by providing several distinct advantages.

First, by their nature, policies that focus on independence and reliance on third-party information in approving compensation diminish the risk of paying greater than fair market value. As the approving body is independent, there are no biases to cause the approval of an excessive amount of compensation. Additionally, because the process is based on a review of objective data, the results of the independent body's analysis are more likely to be within the range of reasonable compensation.

Second, as discussed above, even though the presumption of reasonableness is "rebuttable," the author's firm has never seen the Service undertake the effort to actually challenge the presumption of reasonableness. To rebut the presumption, the Service must develop "sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body" of the charity.[85] This is a fairly high standard, however, and the firm has not seen the Service develop the factual information necessary to rebut a presumption (though there have been situations in which the Service has carefully analyzed the information used to establish the rebuttable presumption before deciding not to pursue intermediate sanctions). Thus, it is clear that the use of the rebuttable presumption, though not a true safe harbor (a pseudo-safe harbor, if you will), is a very effective tool for protecting the organization and its managers from the imposition of intermediate sanctions.

Third, as discussed above, the regulations provide that the reliance on professional advice in approving a transaction precludes the knowing participation in a transaction. Therefore, by instituting a compensation approval policy that requires the organization's governing body to obtain and use the advice of an independent expert in establishing the rebuttable presumption of reasonableness, the organization will automatically protect the members of its governing body from being taxed as organization managers who knowingly

participated in an excess benefit transaction.

CONCLUSION

Executive compensation is a very significant issue for both public charities and the individuals who control them. As such, it is extremely important for organizations to take great care in establishing the amount of compensation for its executives—not only to ensure the organization is retaining the most effective executive personnel, but of equal importance, to protect the organization's tax-exempt status and prevent the imposition of intermediate sanctions, both on the executive and/or the organization's managers. By implementing the appropriate policies and determining compensation based on appropriate data, charities can limit their exposure to the consequences of excess benefit transactions, continue to provide executives with competitive compensation for their services, and avoid an unnecessary and often painful journey through the denial and fear phases of executive compensation.

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For more information, contact Mr. Journy at mtjourny@Venable.com or at 202.344.4589.

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3 Reg. 1.503(c)(3)-1(d)(1)(ii).

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10 United Cancer Council, *supra* note 5 at 165 F.3d 1176.

11 Founding Church of Scientology, 24 AFTR 2d 69-5187, 188 Ct Cl 490, 412 F2d 1197, 69-2 USTC ¶9538 (Ct. Cl., 1969).

12 John Marshall Law School, 48 AFTR 2d 81-5340, 81-2 USTC ¶9514 (Ct. Cl., 1981) at 81-5348.

13 Founding Church of Scientology, 24 AFTR 2d 69-5187, 188 Ct Cl 490, 412 F2d 1197, 69-2 USTC ¶9538; John Marshall Law School, 48 AFTR 2d 81-5340, 81-2 USTC ¶9514.

14 Church of Scientology of California, 60 AFTR 2d 87-5386, 823 F2d 1310, 87-2 USTC ¶9446 (CA-9, 1987).

15 Founding Church of Scientology, *supra* note 11; See also, Mabee Petroleum Corp., 43 AFTR 872, 203 F2d 872, 53-1 USTC ¶9334 (CA-5, 1953) ("The familiar principle that corporate net earnings may not be

channeled to officers in the form of excessive and unreasonable salaries is too well settled to require citation of authority.").

16 See, generally, Section 4958.

17 Reg. 53.4958-4(a)(1).

18 Section 4958(c)(1)(A).

19 *Id.*

20 Reg. 53.4958-2(a)(1).

21 Reg. 53.4958-2(a)(2).

22 Section 4958(f)(1). Other persons may also be disqualified persons, including certain controlled organizations and certain donors and donor advisors. However, such persons are not discussed in this article because they are unlikely to be compensated as officers of an exempt organization. Similarly, only individuals can be compensated as executives, so other entities that may be disqualified persons are not discussed in this article.

23 Reg. 53.4958-3(c)(1).

24 Reg. 53.4958-3(c)(2).

25 Reg. 53.4958-3(c)(3).

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27 Reg. 53.4958-3(e)(1).

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33 Reg. 53.4958-3(e)(2)(vi).

34 Reg. 53.4958-3(e)(3)(i).

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37 Reg. 53.4958-3(e)(3)(iv).

38 For purposes of this definition, family members of disqualified persons are deemed to have substantial influence.

39 Reg. 53.4958-3(d)(3).

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41 Reg. 53.4958-3(b)(1).

42 Reg. 53.4958-1(b).

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44 American Campaign Academy, *supra* note 7 at 1071.

45 *Id.* at 1073.

46 IRM 4.76.3.11.1(3).

47 See Founding Church of Scientology, *supra* note 11 at 412 F.2d 1202 ("If in fact a loan or other payment in addition to salary is a disguised distribution or benefit from the net earnings, the character of the payment is not changed by the fact that the recipient's salary, in increased by the amount of the distribution or benefit, would still have been reasonable.").

48 Section 4958(f)(6).

49 Reg. 53.4958-1(c)(1).

50 Reg. 53.4958-1(c)(2)(i).

51 Reg. 53.4958-1(d)(1).

52 Reg. 53.4958-1(d)(2)(i).

53 Reg. 53.4958-1(d)(3).

54 Reg. 53.4958-1(d)(4)(i).

55 Reg. 53.4958-4(b)(1)(i).

56 Estate of True, TC Memo 2001-167, RIA TC Memo ¶2001-167, 82 CCH TCM 27 , 1184.

57 Estate of Andrews, 79 TC 938 , 956 (1982).

58 Caracci, 98 AFTR 2d 2006-5264, 456 F3d 444, 2006-2 USTC ¶50395 (CA-5, 2006).

59 Reg. 53.4958-4(b)(1)(ii)(B)(1).

60 Reg. 53.4958-4(b)(1)(ii)(B)(3).

61 Reg. 53.4958-4(a)(4).

62 Reg. 53.4958-4(c)(1).

63 Reg. 53.4958-4(c)(2).

64 Reg. 53.4958-4(c)(3)(i)(A)(1).

65 Reg. 53-4958-4(c)(3)(i)(A)(2).

66 Reg. 53.4958-4(c)(3)(ii)(A).

67 Reg. 53.4958-4(c)(3)(ii)(B).

68 Reg. 53.4958-4(c)(3)(ii)(C).

69 Reg. 53.4958-4(b)(1)(ii).

70 Brauer and Henzke, "Intermediate Sanctions (IRC 4958) Update," *Exempt Organizations Continuing Professional Educational Technical Instruction Program for FY 2003* (2002) at E-22.

71 Reg. 53.4958-6(c)(3)(ii).

72 Reg. 53.4958-6.

73 Reg. 53.4958-6(e).

74 Reg. 53.4958-6(c)(3).

75 Reg. 53.4958-1(d)(4)(iii).

76 Form 990, Part IV, Line 25a.

77 Form 990, Schedule J, Part 1, Line 9.

78 Caracci, *supra* note 58.

79 *Id.* at 98 AFTR 2d 2006-5264, 456 F3d 444, 2006-2 USTC ¶50395 (quoting Estate of Dunn, 90 AFTR 2d 2002-5527, 301 F3d 339, 2002-2 USTC ¶60446 (CA-5, 2002)).

80 Ossenfort, Docket No. 024352-10.

81 *Id.*

82 Reg. 53.4958-6(e).

83 Reg. 53.4958-6(b).

84 Reg. 53.4958-4(c)(1).

85 Reg. 53.4958-6(b).

USING SECTION 7428 TO RESOLVE EXEMPT STATUS CONTROVERSIES

MATTHEW T. JOURNY

An organization can use the declaratory judgment provisions of Section 7428 to end a prolonged controversy with the IRS over tax-exempt status.

IRS examinations of tax-exempt organizations can be, and often are, long, arduous processes that can span several years. This is especially true of examinations that result in proposed adverse determinations. During IRS examinations it is important that tax-exempt organizations have the benefit of all available tools and strategies that can be used to exert a greater level of control over the duration of the examination and the administrative appeals process. In some cases the Service's own administrative delays can be used to the advantage of organizations facing potential adverse determinations.

A new strategy adds another arrow to the quiver of tax-exempt organizations subjected to unending IRS examinations regarding their exempt status. They can seek declaratory judgments from the United States Tax Court using a relatively unique interpretation of that court's subject matter jurisdiction over requests for declaratory judgments under Section 7428.

MATTHEW T. JOURNY is an associate in the Nonprofit Organizations Practice of the Venable LLP law firm, based in Washington, DC. He can be reached at 202-344-4589 or at mtjourny@venable.com. This article is not intended to provide legal advice or opinion and should not be relied on as such. Legal advice can be provided only in response to a specific fact situation.

Background

Pursuant to Section 7428, courts have subject matter jurisdiction to issue a declaratory judgment pertaining to an organization's continued qualification for tax-exempt status under Section 501(c)(3). However, under the most conservative understanding of Section 7428, they can do so only after the Service has issued a final adverse determination letter (FADL) and the organization has exhausted all of the administrative remedies available within the Service. In these situations, courts have traditionally held that their jurisdiction over the case is limited to the periods examined by the Service during its examination.

This understanding of the jurisdictional scope of Section 7428 provides little comfort to organizations subjected to extremely long examinations; so long that the facts and law have significantly changed and now differ from those examined by the Service. During such long examinations, the Service essentially is able to hold organizations hostage by refusing to issue a FADL, subjecting them to the strain and expenses of a perpetual examination. Additionally, this understanding of jurisdiction gives the Service unilateral authority to manipulate the facts

that would be considered by a court in a declaratory judgment case by selectively opening for examination only those periods that support the Service's position regarding revocation.

Recognizing these extreme hardships, the author's firm recently filed two petitions for declaratory judgment in which it sought to challenge this overly conservative interpretation of Section 7428. The author's firm sought declaratory judgments from the Tax Court on behalf of two clients whose cases had lingered in the Service's administrative appeals process for more than six years without the issuance of a FADL or any true efforts by the Service to reach a non-adverse resolution. Also, recognizing that the facts and law at the time that the petitions were filed were significantly different from those during the periods examined by the Service, the petitions filed with the Tax Court sought a declaratory judgment regarding the exempt status of each organization for periods subsequent to the examination, in addition to those examined by the Service.

The petitions filed by the author's firm are significant because they introduce an very different interpretation of subject matter jurisdiction under Section 7428. This interpretation does three things:

1. It provides organizations with a mechanism for removing perpetual examinations from the Service's purview by seeking a judicial determination on the issue.
2. It permits a greater number of organizations to seek the judicial remedies provided by Section 7428 by potentially removing the financial hardships associated with receiving a FADL as necessary requirement of obtaining a declaratory judgment.
3. It allows organizations to use proposed revocation letters to address any and all potential exemption issues identified during the examination and seek a judicial ruling based on the revised and improved facts presented in the periods after the issuance of the proposed revocation letter.

As of now, the issues and analysis discussed in this article rest largely in the realm of legal theory. While the author's firm litigated these issues in Tax Court, the cases were settled prior to the issuance of a final decision by the court. However, though these cases failed to result in the desired precedent, there is much to be learned from the court's consideration of these petitions and the Service's strategy throughout the litigation.

The issue

The cases involved two organizations that had each been under examination for nearly a decade, with each organization having received a proposed adverse determination letter more than six years before a Tax Court petition was filed. The extreme duration of these examinations was due partly to delays and retirements within the IRS, and partly to the efforts of the organizations to address the Service's concerns. Specifically, the organizations identified and addressed potential areas of noncompliance—including those discussed in the revenue agent's report (RAR) as the basis for the proposed adverse determination—making the changes necessary to come into compliance with the standards expressed by the Service in the RAR. Despite these efforts, however, the changes made by the organizations did not have the intended effect of hastening non-adverse resolutions to the examination and administrative review process. Rather, these efforts merely caused an indefinite extension of the Service's internal review process, resulting in an administrative stalemate.

A new strategy adds another arrow to the quiver of tax-exempt organizations.

On the one hand, the Service was unwilling to consider any non-adverse resolution, such as a closing agreement, because of what it believed to be substantial issues discovered during its examination. On the other hand, the Service was hesitant to issue a FADL due to the potential litigating hazards presented by organizations, which had used the information in the RAR to resolve any and all compliance issues developed during the IRS examinations and, as such, were compliant with each of the requirements necessary for recognition of tax-exempt status. Essentially, these organizations found themselves in the unfavorable position of having to endure the expense and strain of an unending IRS examination and appeals process while dealing with diminished funds and grants resulting from the public perception about the unresolved examination. Moreover, because it refused to issue a FADL, the Service was depriving these organizations of the congressionally granted right to obtain a relatively prompt judicial review of a final adverse determination regarding their tax-exempt status.

Compounding the harm of the Service's administrative delays was the fact that, even if a court had subject matter jurisdiction over this issue, it would have been the Service's position that the scope of the court's jurisdiction was limited to the periods examined by the Service. Therefore, by expressly refusing to consider any factual information relating to periods after

those examined—even in situations where the Service acknowledged that the substantial organizational changes brought the organization into compliance with the requirements necessary for recognition of tax-exempt status—the Service was effectively precluding any court from ever considering such facts in making its own determination regarding the continued qualification of these organizations for recognition of tax-exempt status.

To relieve these organizations of the substantial burdens of a perpetual IRS examination, the author's firm decided to remove the review of these cases from the Service's purview by filing a petition seeking a declaratory judgment from the Tax Court regarding the tax years examined by the Service and each tax year subsequent to those examined.

During long examinations, the Service essentially can hold organizations hostage by refusing to issue a Final Adverse Determination Letter.

Law and analysis

There were two primary jurisdictional hurdles that could have thwarted obtaining the requested relief. First, the court could have ruled that it lacked that requisite subject matter jurisdiction to grant the requested relief in either case because the Service had not issued a 90-day letter—frequently referred to as the "ticket to Tax Court." Second, even if the court determined that it had subject matter jurisdiction to issue a declaratory judgment, it could have ruled that the scope of its jurisdiction was limited to only those years actually examined by the IRS.

The general jurisdictional requirements of Section 7428. Under Section 7428, the United States Tax Court, the United States District Court for the District of Columbia, and the United States Court of Federal Claims have concurrent jurisdiction to issue a declaratory judgment in the case of an actual controversy with respect to a determination or the Service's failure to make a determination regarding the continued qualification of an organization described in Section 501(c)(3).

To meet the jurisdictional requirements for obtaining a declaratory judgment under Section 7428(a), there must be (1) an actual controversy (2) involving a determination or a failure to make a determination by the Secretary of the Treasury (3) with respect to an organization's initial or continuing qualification or classification as an exempt organization."[1] Additionally, Section 7428(b) provides that a declaratory judgment will not be issued unless the court "determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service."

An organization generally is deemed to have exhausted its administrative remedies as of the earlier of (1) the notice of a final determination or (2) the expiration of the 270-day period. On the second point, Section 7428(b)(2) specifically provides that an organization "shall be deemed to have exhausted its administrative remedies with respect to a failure by the Secretary to make a determination with respect to such issue at the expiration of 270 days after the date on which the request for such determination was made if the organization has taken, in a timely manner, all reasonable steps to secure such determination." In *BBS Associates,* 74 TC 1118 (1980), noting the Service's failure to issue a determination of tax-exempt status after 21 months, the court concluded that the applicant organization had exhausted its administrative remedies after an "inordinately long delay by the [Service] in processing the petitioner's application and arriving at a final determination."[2]

As such, it is clear that once an organization actually receives a FADL, it will have met the jurisdictional requirements for obtaining a declaratory judgment under Section 7428 for the periods under examination. Additionally, it is clear that the court will have subject matter jurisdiction under Section 7428(b)(2) when an organization files a new Form 1023 after its tax-exempt status is revoked, if the Service does not make a determination within 270 days. Another question is less clear, however. Even if the Service has failed to issue a final adverse determination, can an organization satisfy the jurisdictional requirements for obtaining a declaratory judgment for the periods under examination *and* for the periods subsequent to those examined?

Obtaining a declaratory judgment prior to the issuance of a final adverse determination letter. As discussed above, to obtain a declaratory judgment, Section 7428 requires (1) an actual controversy, (2) the Service's failure to make a determination with respect to an organization's request for a determination, and (3) the exhaustion of all administrative remedies available within the Service.

Actual controversy. Courts generally have interpreted the "actual controversy" requirement to mean that "the power to issue declaratory judgments does not extend to advisory opinions on

[1] Gladstone Foundation (hereinafter "Gladstone"), 77 TC 221, 226 (1981).

[2] BBS Associates, 74 TC 1118, 1122 (1980).

[3] AHW Corp, 79 TC 390, 397 (1982).

abstract or hypothetical facts, which do not involve any case or controversy."[3] As such, courts have determined that they lack jurisdiction over cases in which the Service has "not spoken finally with regard to [the] petitioner's status."[4] Therefore, if the Service recognizes an organization as exempt, there generally is "no actual controversy which gives rise to judicial review unless the IRS directly determines that the organization is no longer exempt."[5]

While a final adverse determination is generally required for an actual controversy to exist, courts have noted that an "exception to this requirement ... exists when jurisdiction is invoked under Section 7428(a)(2) on the ground that respondent has failed to make a determination as to initial or continuing qualification."[6] Further, in *Gladstone,*[7] the Tax Court specifically found that the Section 7428(a)(2) exception applied both to organizations seeking a determination regarding initial qualification for exempt status and to organizations seeking a determination regarding continued qualification of exempt status, noting that "Congress clearly intended that declaratory judgment actions as to tax-exempt status ... be available remedies for revocation cases where final determinations were made and where there has been a failure to make a determination."[8] Thus, according to the *Gladstone* court, Congress intended to provide a judicial remedy to an organization if the Service has failed to issue a final determination regarding either the initial or continuing qualification for exempt status.

In *Gladstone*, the court found the existence of an actual controversy with respect to an organization's continuing qualification for exempt status where the Service initiated proceedings to revoke the classification of an organization's tax-exempt status through the issuance of a proposed revocation letter.[9] Thus, an actual controversy may exist where an organization, even one that is already recognized as exempt, requests a determination regarding its continuing qualification and does not receive such a determination from the Service.

In *Anclote Psychiatric Center,* 98 TC 374 (1992) the Tax Court considered an organization that was the subject of a prolonged examination and had not received a final or a proposed revocation letter. The Tax Court determined that, where the organization received notice that the Service's National Office had reviewed and approved the Service's proposed adverse determination through the issuance of a technical advice memorandum, the final revocation was inevitable. Once the issuance of the final adverse determination became inevitable, the court noted that "[t]here can be no other conclusion but that an actual controversy existed."[10]

Like the petitioner in *Anclote*, organizations that have received a proposed revocation from the IRS, have had their Appeals Conferences of Right, and have been informed that the Appeals Division will uphold the proposed revocations, have reached the point where the "final revocation is inevitable." Thus, an actual controversy will exist.

However, while the courts in *Gladstone* and *Anclote* found an actual controversy once the Service issued a proposed revocation and the final determination became inevitable, it is notable that each of these courts ruled that it had jurisdiction to issue a declaratory judgment under the Section 7428(a)(2) exception discussed in *AHW Corp.* and *Founding Church of Scientology*—i.e., that the Service failed to make a determination regarding the organization's exempt status. Therefore, organizations seeking a declaratory judgment prior to the receipt of a final adverse determination must demonstrate that they requested a determination regarding their continued qualification for tax-exempt status and that the Service did not make a final determination with respect to such request.

Courts have determined that they lack jurisdiction over cases in which the Service has 'not spoken finally with regard to [the] petitioner's status.'

[4] *Id.* at 377.

[5] Urantia Foundation, 77 TC 507, 513 (1981). See also High Adventure Ministries, 80 TC 292 (1983) (the mere threat of a notice of proposed revocation does not give rise to an actual controversy); Founding Church of Scientology of Washington, D.C., 69 AFTR2d 92-1385 (1992) (holding that there was no actual controversy where an organization sought a declaratory judgment after the Service issued the organization a no change letter upon completion of its examination); and AHW Corp., *supra* note 2 (the court lacked jurisdiction to issue a declaratory judgment with respect to whether an organization recognized as exempt could engage in a particular activity without jeopardizing its exempt status).

[6] AHW Corp., note 2, at 398. See also, Founding Church of Scientology ("An actual controversy may exist when the IRS fails to make a determination, see I.R.C. § 7428(a)(2), so long as the petitioner/plaintiff waits 270 days after the date on which the request for such determination was made").

[7] Note 1, *supra.*

[8] *Id*. at 229 (citing Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976* (hereinafter, "the Blue Book"), page 403.

[9] Gladstone, *supra* note 1 at 226. ("Although petitioner retained its nonprivate foundation status throughout the administrative process, its continuing classification is unquestionably in issue.")

[10] Anclote Psychiatric Center, 98 TC 374, 378.

Failure to make a determination with respect to a request for a determination. For a court to have jurisdiction to make a declaratory judgment due to the Service's failure to make a determination pursuant to Section 7428(a)(2), an organization must first make a request for such a determination. This usually is done by submitting a Form 1023, "Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code."

In *New York County Health Services Review Organization, Inc.*, 45 AFTR2d 80-1552 (DC N.Y., 1980) (hereinafter *NYCHSRO*), after noting that the Service's procedures required taxpayers to request determinations by submitting a Form 1023, the district court ruled that "[u]ntil such time as the Service either rules on plaintiff's Form 1023 request for determination, or fails to act on such a request within 270 days of its filing, this Court lacks subject matter jurisdiction."[11]

Once the issuance of the final adverse determination became inevitable, '[t]here can be no other conclusion but that an actual controversy existed.'

The ruling in *NYCHSRO* was based on the procedures for obtaining a determination to which Section 7428 applies as provided by Rev. Proc. 77-21, 1977-1 CB 586. Rev. Proc. 77-21, which has since been superseded by Rev. Proc. 2013-9, 2013-2 IRB 255, provided that organizations seeking determinations regarding their tax-exempt status were required to follow the procedures of Rev. Proc. 72-4 regarding the filing of a Form 1023.[12] However, Rev. Proc. 72-4, 1972-1 CB 706, since superseded by Rev. Proc. 2013-9, generally provides that a ruling or determination letter recognizing exemption will not be issued if an issue involving the organization's exempt status is in pending litigation or under consideration within the Service.[13]

As such, the court in *NYCHSRO* determined that it lacked subject matter jurisdiction under Section 7428(a)(2) unless the taxpayer received an adverse ruling regarding a determination requested pursuant to Rev. Proc. 72-4. However, the revenue procedure under which taxpayers were to request a determination necessary for the court's jurisdiction precluded organizations such as the New York County Health Service Review Organization from obtaining the determination required by the court's decision. Therefore, reading the ruling in *NYCHSRO* in conjunction with Rev. Proc. 2013-9, it appears as though the court will lack jurisdiction over the intervening periods until such time as the taxpayer requests and receives a determination that the Service's internal procedures will not allow the IRS to make.

In *Gladstone*, the Tax Court had a different interpretation of this requirement, finding that "Congress clearly intended that declaratory judgment actions as to tax-exempt status ... be available remedies for revocation cases where final determinations were made and where there has been a failure to make a determination."[14] As Rev. Proc. 2013-9 precludes the Service from making determinations on the continuing qualification of organizations whose status is under consideration by the Service, it is inconsistent with Congressional intent and thus is inapplicable to requests from organizations whose exempt status is under consideration by the Service. Based on its understanding of Congressional intent, the *Gladstone* court determined that, where an organization filed a written protest to a proposed revocation that contained a written statement in support of its continued exemption, the organization had made a request for a determination.[15]

The *Gladstone* court specifically considered the decision in *NYCHSRO* and rejected that court's determination that courts lack jurisdiction to issue a declaratory judgment until an organization files a new Form 1023. Noting that the filing of another Form 1023 would be wasteful where "the organization has substantially complete[d the] administrative process by protest and appeals,"[16] the Tax Court determined that such a requirement would provide no additional value, only additional delay, stating that the "respondent's position would not change, but petitioner would suffer additional delays in obtaining a final ruling from a court."[17]

Exhaustion of administrative remedies within the Service. Although the 270-day period creates a presumption that an organization has exhausted

[11] New York County Health Services Review Organization, Inc., 45 AFTR2d 80-1552 (DC N.Y., 1980) at 80-1553.

[12] Rev. Proc. 77-21, 1977-1 CB 586, section 3.01.

[13] See Rev. Proc. 72-4, 1972-1 CB 706, section 5.04. Rev. Proc. 72-4 has been superseded multiple times; its most recent iteration is Rev. Proc. 2013-9, which provides a similar standard for issuing final determination letters in section 4.04. The most significant difference in the relevant sections of these procedures is the additional language of Rev. Proc. 2013-9 section 4.04, which provides that "[i]f the Service declines to issue a determination or ruling to an organization seeking exempt status under § 501(c)(3), the organization may be able to pursue a declaratory judgment under § 7428 provided that it has exhausted its administrative remedies."

[14] Gladstone, *supra* note 1 at 229, citing the Blue Book at page 403 (emphasis added).

[15] See also Anclote, *supra* note 10 at 381 ("a written protest to a proposed revocation is a 'request for a determination' within the meaning of section 7428(b)(2)").

[16] Gladstone, *supra* note 1 at 253.

[17] *Id.*

its administrative remedies, the expiration of 270 days alone does not satisfy the jurisdictional requirements for a declaratory judgment.[18] An organization must have also taken, "in a timely manner, all reasonable steps to secure a ruling or determination."[19] When determining whether an organization has exhausted its administrative remedies under this standard, the courts have looked both to the organization's initial request for a determination and to its subsequent requests for the Service to take action.

In *Gladstone*, the petitioner filed a timely protest letter, communicated regularly with the Service, and submitted all documents requested by the Service in an expeditious manner. The Service, however, argued that the organization had not exhausted its administrative remedies because the Service had not issued a final determination letter prior to the filing of the petition. Taking notice of the petitioner's cooperation with the Service and the Service's failure to act within 29 months of receiving the protest letter, the court ruled that Section 7428 "was intended to provide a remedy for hardships caused by undue administrative delays."[20] Similarly, in *Anclote*, the court determined that an organization "took all reasonable steps to secure a determination"[21] where the record did not indicate that the organization failed to timely submit any requested information and had reached the point at which it had no more administrative appeals available within the Service.

Facts from tax years after those examined under Section 7428. For organizations that are subject to prolonged examinations and administrative review processes, it is important for the court to have jurisdiction over both the periods actually examined and each subsequent period. This is necessary so that the organization can protect itself from the possibility that the Service will intentionally exclude certain facts that do not support the basis for the proposed adverse determination as discussed in the RAR. Moreover, because such changes would have been made during periods subsequent to the issuance of the proposed revocation, it is likely that such changes will have been made in direct response to the issues raised in the RAR. Therefore, it will be important for the organization that the court be able to consider the revised activities, which likely would substantially weaken the Service's position regarding revocation.

Though the exact question regarding the scope of a court's review has never truly been analyzed, it is notable that the Code is silent with respect to the periods over which a court has subject matter jurisdiction. Absent any specific statutory provision limiting the periods for which a court has jurisdiction over a matter, courts have looked to the general requirements for jurisdiction when deciding whether they have subject matter jurisdiction over a particular period. Thus, in the situation of an organization that has requested a determination through the filing of a written protest, the issue of whether a court will have jurisdiction over a particular period is not determined on the basis of whether the period was examined by the Service. Rather, a determination as to whether a court has jurisdiction over the periods subsequent to the periods examined should be based on (1) whether there is an actual controversy regarding the continued recognition of an organization's tax-exempt status and (2) whether the organization exhausted its administrative remedies with respect to its request for a determination.

It is important for the court to have jurisdiction over both the periods actually examined and each subsequent period.

Whether an actual controversy exists over periods subsequent to those examined. The Service's prospective application of an adverse determination is clear. When the Service revokes its recognition of an organization's tax-exempt status, it announces two things. First, that the organization is no longer recognized as an organization exempt from tax. Second, that the organization must file Forms 1120 for all periods subsequent to the effective date of the revocation unless and until the organization reapplies and is again recognized as an organization described in Section 501(c)(3). Similarly, because recognition of tax-exempt status is applied prospectively beginning no later than the date of the request, a request in year one is a request for all subsequent years until a determination is received and, if applicable, subsequently revoked.

Generally, Section 501(a)(1) provides that an organization described under Section 501(c) "shall be exempt from income tax under this

[18] See Prince Corp., 67 TC 318 (1976) (rejecting the petitioner's argument that the Code creates a *per se* test for exhaustion of administrative remedies based on the mere lapse of 270 days); Clawson, TCM 1993-174 (even where the Service made an adverse determination, the court lacked jurisdiction to issue a declaratory judgment because the taxpayer did not exhaust its administrative remedies where the taxpayer failed to protest the proposed revocation); McManus, 93 TC 79 (1981) (even where the Service made an adverse determination, the court lacked jurisdiction to issue a declaratory judgment because the taxpayer did not take any steps to obtain a favorable ruling after making the initial request for a determination).

[19] Reg. 601.201(n)(7)(v)(b).

[20] Gladstone, *supra* note 1 at 236.

[21] Anclote, *supra* note 10 at 383.

subtitle." Reg. 1.501(a)(1) notes that "Section 501(a) provides an exemption from income taxes for organizations which are described in section 501(c)." Thus, it is clear that Congress, not the Service, grants tax-exempt status under Section 501(c). However, to be treated as an organization described in Section 501(c)(3), the Code requires organizations to notify the Service of their qualification for such status.

Section 508(a)(1) provides that no organization will be treated as an organization described in Section 501(c)(3) "unless it has given *notice* to the Secretary, in such manner as the Secretary may by regulations prescribe, that it is applying for *recognition* of such status." (Emphasis added.) As such, the Service's application and determination process is not the process by which an organization becomes entitled to tax-exempt status; such entitlement was created by Congress. Rather, the application and determination process is merely the administrative process through which an organization *notifies* the Service that it wishes to be *treated* as an organization whose tax-exempt status was granted by Congressional authority.

The Code is silent with respect to the periods over which a court has subject matter jurisdiction.

Through the promulgation of regulations and administrative guidance, the Service has established the procedures by which an organization must notify the Service of its desire to be recognized as an organization described in Section 501(c)(3). Reg. 1.508-1(a)(2) provides that an organization must file "a properly completed and executed Form 1023" that is submitted "within 15 months from the end of the month in which the organization was organized." The regulations also provide an automatic 12-month extension to the 15-month period within which to file the notice required under Section 508.[22]

The regulations provide that, unless notice is provided to the Service within the required period, "[n]o organization shall be exempt from taxation under section 501(a) by reason of being described in section 501(c)(3)."[23] Therefore, if an organization files its Form 1023 within 27 months of the end of the month in which it is organized, it will be treated as a tax-exempt organization described in Section 501(c)(3) for its entire existence. However, if an organization files a Form 1023 more than 27 months after the end of the month in which it was organized, it will generally be treated as exempt as of the date on which it submitted its Form 1023. The regulations do provide equitable relief in certain situations.

Reg. 301.9100-3(a) gives the Service the ability to grant a discretionary extension of time to make an election when "the taxpayer provides evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the Government." Evidence that a taxpayer acted reasonably and in good faith includes evidence that the taxpayer both:

1. Failed to make the election because of intervening events beyond the control of the taxpayer.[24]
2. Reasonably relied on the written advice of the Service.[25]

The regulations provide that relief will prejudice the interests of the government if the "granting of relief would result in a taxpayer having a lower tax liability in the aggregate for all tax years affected by the election than the taxpayer would have had if the election had been timely made."[26]

In addition to the regulations, the Service annually publishes administrative guidance pertaining to the notification requirements of Section 508(a). In Rev. Proc. 2013-9, the Service has provided administrative guidance with respect to the manner in which it will process and review applications for recognition of exempt status. As discussed above, section 4.04 (entitled "No letter if exempt status issue in litigation or under consideration within the Service") provides that a determination letter will not ordinarily be issued while an organization's tax-exempt status is the subject of litigation or internal review, such as an examination.

The Code and the regulations provide that, upon receipt of a FADL, an organization will not be recognized as exempt for any period subsequent to the applicable date of the revocation until it files the required notice with the Service. However, based on Rev. Proc. 2013-9, the Service will not review or process a Form 1023 until the issue is no longer under internal review or the subject of litigation.[27] As such, the Service's procedural rules for processing

[22] Reg. 301.9100-2(a)(2)(iv).

[23] Reg. 1.508-1(a)(1).

[24] Reg. 301.9100-3(b)(ii).

[25] Reg. 301.9100-3(b)(iv).

[26] Blue Book at 402.

[27] This is consistent with information provided in discussions with the Service and with the Service's processing of the multiple Forms 1023 filed by the author's firm on behalf of clients in preparation of making this argument in litigation.

Forms 1023 preclude organizations subject to a proposed revocation from seeking a determination in the manner proscribed. This essentially precludes such organizations from obtaining recognition of exempt status for any period subsequent to the periods examined and prior to the final resolution of the case, including all litigation under Section 7428. Through the development and implementation of administrative procedures that preclude its review of a Form 1023 prior to the issuance of a final determination letter and the conclusion of litigation relating to that determination, the Service has effectively usurped Congress' authority to grant tax-exempt status under Section 501(a). Further, to the extent that an adverse determination is applied prospectively to periods for which an organization cannot request a determination, the Service's determination with respect to prior periods is a final and unreviewable determination for each period subsequent to those examined.

The abusive effect of the Service's unauthorized expansion of power is compounded because it deters taxpayers from availing themselves of their congressionally created right to judicial review of an adverse determination pursuant to Section 7428. Because the Service will not process Forms 1023 submitted by organizations whose exemption is the subject of litigation, an organization seeking a declaratory judgment under Section 7428 prolongs the period for which it is unable to obtain a determination from the Service, potentially causing additional harm by extending the period for which the organization is deemed to be revoked with no possibility of administrative or judicial review. This is especially concerning in light of the legislative history, which demonstrated that Section 7428 was added to the Code in response to the Supreme Court's warnings about the significant harm and potential for abuse that could result from the Service's unrestrained authority to make determinations regarding the tax-exempt status of public charities.

In discussing the newly enacted Section 7428, the Staff of the Joint Committee on taxation referred to the U.S. Supreme Court's decision in *Bob Jones University,* 416 U.S. 725, 33 AFTR2d 74-1279 (1974). According to the Joint Committee staff:

> The degree of bureaucratic control that, practically speaking, has been placed in the Service over those in petitioner's position [i.e., the position of Bob Jones University] is susceptible to abuse, regardless of how conscientiously the Service may attempt to carry out its responsibilities.... Accordingly, the Congress agreed to provide in this Act for a declaratory judgment procedure under which an organization can obtain a judicial determination of its own status as a charitable, etc., organization.[28]

This statement of the Joint Committee staff, in setting out the very purpose of Section 4728, stands in contrast to the Service's position. The Service's argument—that a court lacks subject matter jurisdiction to issue a declaratory judgment under Section 7428 if the judgment being sought relates to periods for which an organization is revoked and cannot obtain administrative review—runs contrary to the very purpose of the law as explained by the Joint Committee explanation.

Even if the Service's procedures did not prevent organizations whose exempt status is the subject of litigation or IRS review from obtaining a determination, it would be unnecessary for organizations protesting a proposed revocation to file a Form 1023 for a court to have jurisdiction under Section 7428. As noted above, the Tax Court in *Gladstone* stated that requiring an organization to file a duplicative Form 1023 "would be wasteful."[29] The court determined that such duplicative filings were unnecessary because:

> [W]here an original Form 1023 is on file for the organization, the organization has substantially completed the administrative process by protest and appeal. A new Form 1023 would only supply the same information. If a new Form 1023 was required to be filed and an adverse determination was attained therefrom, the organization would be required to complete another protest and appeal procedure before it would be deemed to have exhausted its administrative remedies. Of what value is this additional appeal procedure where it is simply a rehashing of the same issues and facts involved in the first appeal procedure initiated as a result of the proposed revocation? The respondent's position would not change, but petitioner would suffer additional delays in obtaining a final ruling from a court.[30]

A determination letter will not ordinarily be issued while an organization's tax-exempt status is the subject of litigation or internal review.

Exhaustion of administrative remedies available within the IRS. In addition to requiring either a determination or the failure to make a determination, as noted above, Section 7428(b)(2) provides that a declaratory judgment will not be issued unless the court "determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service."

In determining whether Section 7428 grants jurisdiction over periods subsequent to those examined, courts have primarily focused on

[28] Blue Book at 402.
[29] Gladstone, *supra* note 1 at 234.
[30] *Id.*

whether the taxpayer had exhausted its administrative remedies for such periods. In *Synanon Church,* 557 F Supp 1329, 51 AFTR2d 83-979 (DC D.C., 1983), the court noted that an adverse determination granted the court jurisdiction upon exhaustion of the organization's administrative remedies, and that the adverse determination "does not serve as a final decision eliminating any requirement for plaintiff to seek further administrative relief. Rather, it shifts the burden of taking further action to restore its exempt status."[31] As such, the court determined that "if plaintiff believes that it should be declared exempt for its activities in [the periods subsequent to those examined], it should petition for exempt status for those years."[32] Once Synanon Church exhausted all of its administrative remedies for those periods, the court would have jurisdiction with respect to the Service's determination. Thus, pursuant to *Synanon Church*, for a court to have jurisdiction to make a declaratory judgment over any period subsequent to the periods examined by the Service, an organization must request a determination from the Service and exhaust its administrative remedies with respect to such request for each period.

The Service's argument runs contrary to the very purpose of the law as explained by the Joint Committee explanation.

As discussed above, during the appeal of a proposed adverse determination and the pendency of litigation on a FADL, the Service is administratively unable to process, review, or issue a determination on any Form 1023 filed prior to the issuance of the FADL and the conclusion of any court proceeding brought under Section 7428. As such, the requirement for exhaustion noted by the court in *Foundation of Human Understanding.,* 104 AFTR2d 2009-5424 (Fed. Cl. Ct., 2009), that "if plaintiff believes that it should be declared exempt for any tax year subsequent to those which formed the subject of defendant's audit, 'it should petition for exempt status for those years,'"[33] is moot because the procedures established by Rev. Proc. 2013-9 preclude the consideration of any "petition for exempt status" during the pendency of the litigation or appeals process.

Additionally, because the internal procedures established by Rev. Proc. 2013-9 preclude the Service from making a determination with respect to a Form 1023 during the pendency of the IRS appeals and litigation, there will be no determination to appeal and no administrative remedy available to the organization. Moreover, upon issuance of a final adverse determination and the conclusion of any court proceeding brought under Section 7428, one or more years subsequent to the years examined by the Service will have closed by the time the Service is finally able to process a Form 1023. As such, the taxpayer will be unable to request a ruling for the revoked years never examined by the Service, and the Service will be unable to issue a determination with respect to such years. Thus, it is a procedural impossibility for an organization to secure a determination from the Service with respect to any tax year beginning after the years actually examined by the Service and ending prior to the conclusion of any court proceeding brought under Section 7428, including all appropriate appeals.

Under the circumstances discussed above, the substantial harm created by the procedural obstacles to obtaining a ruling on a Form 1023 cannot be remedied by the relief provided in Reg. 301.9100-3 because it would be inappropriate for the Service to grant a revoked organization relief under that regulation. Even if the organization acted reasonably and in good faith, because its failure to timely file a Form 1023 was a result of events beyond its control,[34] and based on oral and written statements made by the Service,[35] the available relief would be prohibited because it would prejudice the interest of the government.

As discussed above, the Service's authority to grant relief under Reg. 301.9100-3 is limited to extending the 27-month period within which an organization can file a Form 1023 to the date on which it actually filed its new Form 1023. Upon granting such an extension, a favorable

[31] Synanon Church, 557 F Supp 1329, 51 AFTR2d 83-979, 83-982 (DC D.C., 1983). See also Foundation of Human Understanding, 104 AFTR2d 2009-5424 (Fed. Cl. Ct., 2009) (following Synanon Church and stating "[b]ecause the IRS's revocation was not a final and prospective determination, the Synanon court concluded that the plaintiff had not fulfilled the § 7428(b)(2) requirement that a taxpayer exhaust all available administrative remedies before filing suit for declaratory judgment," and holding that "if plaintiff believes that it should be declared exempt for any years subsequent to those which formed the subject defendant's audit, 'it should petition for exempt status for those years.'"). *Id.* at 2009-5431.

[32] Synanon Church, *supra* note 31 at 51 AFTR2d at 83-982.

[33] Foundation of Human Understanding, *supra* note 32 at 104 AFTR2d 2009-5431.

[34] Reg. 301.9100-3(b)(ii).

[35] Reg. 301.9100-3(b)(iv).

[36] IRM 35.3.2.1(3). See also IRM 35.3.8.2(1) ("Although jurisdictional motions may be filed at any time, if possible, such motions should be filed within 45 days after service of the petition"); and IRM 35.3.2.2(1) (Providing that a motion to dismiss for lack of jurisdiction "should be filed with the court, if possible, before the answer due date").

determination on the organization's application would result in its treatment as an organization described in Section 501(c)(3) for all periods since the organization's creation. This relief would prejudice the government by effectively reversing the Service's prior revocation, which was the event that necessitated the taxpayer's request for relief under Reg. 301.9100-3. Therefore, with respect to Forms 1023 filed after the issuance of a FADL, it is inappropriate for the Service to grant relief under Reg. 301.9100-3 because the "granting of relief would result in a taxpayer having a lower tax liability in the aggregate for all tax years affected by the election than the taxpayer would have had if the election had been timely made."

Pursuant to the process that it has implemented to administer Section 508(a), the Service is procedurally unable to make a determination with respect to a Form 1023 submitted by an organization for any period subsequent to an examination until the issuance of the FADL and the conclusion of all judicial proceedings. Therefore, unlike the situations considered by the courts in *Synanon* and *Foundation for Human Understanding*, an adverse determination regarding periods examined by the Service is a final determination for all subsequent periods until the conclusion of litigation on the matter.

The burden placed on a taxpayer is not the burden of obtaining a determination that the Service is administratively incapable of providing. Rather, the taxpayer's burden is simply to exhaust all administrative remedies respecting the Service's final determination. However, because Rev. Proc. 2013-9 precludes a taxpayer from obtaining a determination regarding the exempt status for such periods, there are no administrative appeals available respecting the Service's determination. The fact that there are no administrative appeals available to the taxpayer, in this situation, is empirical evidence "that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service" as required by Section 7428(b)(2).

In *Synanon* and *Foundation of Human Understanding*, the courts held that, for a court to have subject matter jurisdiction over a tax period, an organization had to request a ruling and exhaust all administrative remedies available within the Service. As a taxpayer subjected to prolonged examination and appeals processes will have filed a protest to a proposed revocation, pursuant to the Tax Court decisions in *Gladstone* and *Anclote*, it will have made a "request for a determination" for purposes of Section 7428. As the Service's internal procedures provide organizations subject to a proposed revocation with no administrative remedies other than the appeals process for the years examined, and no administrative remedies at all with regard to years subsequent to those examined, such an organization will have necessarily exhausted all available remedies by virtue of the passage of more than 270 days from the filing of the protest. Such an organization will have made a request for a determination and exhausted all of the administrative remedies available with respect to the periods subsequent to the Service's examination in addition to the periods actually examined by the Service. Therefore, the organization will have satisfied all jurisdictional requirements to obtain a declaratory judgment with respect to both the periods under examination and the periods subsequent to those examined by the Service.

Results

As previously discussed, the cases filed by the author's firm were settled prior to a final decision by the court. As such, the theories and arguments presented in this article lack the desired precedential authority and remain subject to interpretation. However, the manner in which the cases were handled by the Office of Chief Counsel and the Tax Court adds to the credibility of the arguments presented and does not diminish the usefulness of this approach. Specifically, once a petition was filed:

1. Neither the Service nor the Tax Court challenged the court's jurisdiction over the underlying issues presented by the case
2. Within a year of filing a petition, the Service agreed to enter into a closing agreement that it had turned down multiple times in the four years prior to litigation.

Neither the IRS nor the Tax Court questioned the court's jurisdiction over this matter. Though not precedential in any way, the best indication of the strength of the jurisdictional arguments supporting petitions filed under the theories discussed in this article was the Service's reaction to the petitions. The Internal Revenue Manual (IRM) is very clear about timing for raising jurisdictional issues in Tax Court cases, stating that a "jurisdictional defect should be raised in a motion to dismiss for lack of jurisdiction as soon as the jurisdictional defect is discovered."[36]

Whether employer-provided lodging is located 'on the business premises' has generated substantial litigation.

There were two such jurisdictional defects that should have been raised by the Service in the petitions filed by the author's firm. First, neither petitioner received an adverse determination prior to filing a petition for declaratory judgment in Tax Court.[37] Second, both petitioners sought a determination for periods outside the scope of the proposed adverse determination.[38] However, without regard to the requirements of the Service's own IRM, the Service decided not to raise any jurisdictional issues at any point during the litigation of either case.

The real benefit to tax-exempt organizations was the Service's reaction to the petitions.

Not only did the Service fail to raise any questions respecting the court's jurisdiction over the relief requested in the petition, but the court also failed to question its own jurisdiction over such matters. Thus, there is anecdotal evidence supporting the proposition that the Tax Court had jurisdiction to grant the relief requested in the petitions.

A non-adverse settlement. The failure of the Service to question the court's jurisdiction over the petitions filed by the author's firm supports the jurisdictional arguments made in this argument. However, such support is more academic than practical and of little use to most tax-exempt organizations. The real benefit to tax-exempt organizations was the Service's reaction to the petitions. In both cases, rather than litigate issues when it was unsure of its probability of success and wary of the consequences of losing, the Service decided to enter into favorable closing agreements that continued to recognize each organization as exempt.

Every organization is different, and an organization that repeatedly and continually violates the requirements of Section 501(c)(3) will be less likely to obtain a favorable agreement with the Service. However, for organizations that have used the information contained in a proposed revocation letter as a guide for bringing themselves into compliance with the requirements of the Code, as interpreted by the Service, it appears that the litigating hazards may prompt the IRS to enter into a closing agreement.

The benefit of an expanded interpretation of Section 7428

The strategies discussed above can provide organizations with a means to exert greater control over IRS examinations, possibly reaching quick, non-adverse resolutions to exceptionally long examinations. The most significant benefits resulting from the use of these strategies include:

1. Control over the duration of an examination.
2. The admissibility of evidence from years subsequent to those examined by the IRS.
3. Eliminating the taxpayer's burden of proof during an examination.
4. Possibly enjoining the Service from issuing a final adverse determination during pendency of litigation.

Control over duration and review. As discussed above, the genesis of this strategy was the extreme length of the Service's administrative review process in its examinations and the adverse impact caused by the Service's delays. This strategy will give tax-exempt organizations a method of exacting some control over the duration of an examination, permitting taxpayers to decide for themselves when to end the examination process.

Another advantage is that this strategy will provide practitioners with control over who within the Service has the administrative jurisdiction to review the case. For instance, if a possible settlement of an issue is stymied by an uncooperative Appeals Officer, this strategy will allow the taxpayer to remove the case from the jurisdictional purview of the Appeals Division by filing a petition in Tax Court and conferring jurisdiction on the Office of Chief Counsel, thereby removing the primary obstacle to a settlement.

Better use of the RAR. If Section 7428 is understood to confer subject matter jurisdiction over periods subsequent to an examination, then organizations that receive a proposed adverse determination can use the information in the RAR as a guide for bringing themselves into compliance with the Service's desired practices. If, prior to the issuance of a FADL, an organization is able to address and resolve each of the grounds for revocation discussed in the RAR, judicial consideration of the revised activities will render the Service's position as discussed in the RAR moot. This will also provide taxpayers with greater control over

[37] See IRM 35.3.8.2(1)(b). ("If no determination has been made regarding the petitioner's qualification for tax-exempt status, the "a motion to dismiss for lack of jurisdiction is proper.")

[38] See IRM 35.3.2.6(1). ("If petitioner attempts to place in controversy a year or tax in which the statutory notice did not determine a deficiency, a jurisdictional motion with respect to the case should be filed.")

their future because it will allow them to see the manner in which the Service would prefer they operate, then make a decision as to whether it is in the organization's best interest to make the changes necessary to comport its activities with the Service's desired practices before undertaking the burden and expense of litigation.

Additionally, if the organization is willing and able to make the changes necessary to bring itself into compliance with the Service's position as provided by the RAR, it may be able to enter into a closing agreement resulting in prospective recognition of its tax-exempt status without ever receiving a FADL. If periods subsequent to an IRS examination are considered by a court, addressing the issues raised in the RAR will substantially increase the litigating hazards of a case, increasing the probability of settlement at the appeals level. This will result in two substantial benefits. First, it will prevent the issuance of the FADL resulting in continuous recognition of tax-exempt status. Second, unlike a subsequent Form 1023, which would be subject to public disclosure, a closing agreement would be a confidential document preventing the public disclosure of the Service's negative impression of the organization's prior activities.

Burden of proof in court. The Service's position in a notice of deficiency or determination letter generally is afforded the presumption of correctness, thereby imposing the burden of proof on the taxpayer. However, to the extent that there is no final determination, there is no position to presume to be correct. As briefly discussed in the Tax Court's concurring opinion in *Gladstone*, by seeking a judicial remedy before the issuance of a FADL, taxpayers can effectively relieve themselves of this burden in litigating the exemption matter.[39]

Enjoining a final adverse determination during the litigation. The final potential benefit of this strategy is the most significant and the most uncertain. If an organization removes the determination regarding its tax-exempt status from the Service's purview by filing a petition seeking a declaratory judgment before the issuance of a FADL, it can be argued that the court, not the Service, will have the sole jurisdictional authority to make a final determination regarding the organization's tax-exempt status. As such, it may be possible for the taxpayer to enjoin the Service from issuing a FADL during the pendency of litigation.[40]

Courts generally have deemed efforts to enjoin the Service from making a determination, such as revocation of tax-exempt status, to be an attempt to restrain the assessment or collection of income taxes. As such, Section 7421(a), the Anti-Injunction Act, generally prohibits efforts to enjoin the Service from issuing a FADL unless there are extraordinary circumstances or there is a specific statutory exception permitting the requested relief. Thus, there is an extremely high standard for obtaining a preliminary injunction against the Service's issuance of FADL.

For purposes of the Anti-Injunction Act, the Supreme Court has determined that extraordinary circumstances permitted injunctive relief where the taxpayer could demonstrate both that because of the Service's action "the taxpayer would suffer irreparable injury," and "that under no circumstances could the Government ultimately prevail."[41] A determination regarding the "extraordinary circumstance" exception requires a decision on the underlying merits of the case making it difficult to satisfy this standard in a preliminary hearing. Therefore, to obtain a preliminary injunction against the issuance of a FADL, an organization will likely be required to demonstrate that the requested relief meets a statutory exclusion from the Anti-Injunction Act.

An organization should consider including language in its protest that specifically requests a determination regarding ongoing recognition of its exempt status.

With respect to petitions for declaratory judgment, two possible statutory exceptions to the Anti-Injunction Act would permit a preliminary injunction. First, as Section 7428 is expressly exempted from the Declaratory Judgment Act's general prohibition on declaratory judgments in tax cases, Section 7428 provides a statutory exception from the Anti-Injunction Act under the coterminous interpretation of those statutes. Second, depending on the procedural status of the case, the court may enjoin the Service from issuing an FADL pursuant to

[39] Gladstone, *supra* note 1 at 237.

[40] In one of the cases litigated by the author's firm, the Tax Court held a hearing on a motion for preliminary injunction seeking to restrain the issuance of a FADL during the pendency of the litigation. The issue remains unsettled, however, because the Tax Court failed to rule on the motion in the more than seven months that elapsed before that case was settled and the parties filed a joint motion to dismiss the case.

[41] Enochs v. Williams Packing & Navigation Co., 370 U.S. 1, 7, 9 AFTR2d 1594 (1962).

the Administrative Procedure Act if the Service failed to follow its own procedures.[42]

Section 7428 exception to the Anti-Injunction Act. Petitions for declaratory judgment brought under Section 7428 are expressly excluded from the Declaratory Judgment Act's general prohibition on declaratory judgments in tax cases. The Declaratory Judgment Act states:

> In a case of actual controversy within its jurisdiction, except with respect to Federal taxes other than actions brought under *section 7428 of the Internal Revenue Code of 1986* ... any court of the United States, upon the filing of an appropriate pleading, may declare the rights and other legal relations of any interested party seeking such declaration, whether or not further relief is or could be sought.[43]

It may be beneficial for the organization to file a complete Form 1023 with the Service during the pendency of its administrative appeals process.

Applicable case law holds that the Declaratory Judgment Act is coextensive and coterminous with the Anti-Injunction Act, such that an action brought under one statute will not preclude the relief afforded by the other.[44] Therefore, where a taxpayer seeks a declaratory judgment under the Section 7428 exception to the Declaratory Judgment Act, the Anti-Injunction Act will not prevent the court from granting the injunctive relief sought by the organization. Any other outcome would produce the anomalous result of a court having jurisdiction to enter declaratory relief under Section 7428 but lacking the authority to enforce its order under the Anti-Injunction Act.

In *Cohen*, 650 F.3d 717, 727-31, 108 AFTR2d 2011-5046 (CA-D.C., 2011), the D.C. Circuit held that the Anti-Injunction Act and Declaratory Judgment Act are coterminous, such that a court could grant declaratory relief in an action allowed under the Anti-Injunction Act notwithstanding the Declaratory Judgment Act's general prohibition on declaratory judgments in tax cases.[45] To support its ruling, the D.C. Circuit found that "an injunction of a tax and a judicial declaration that a tax is illegal have the same prohibitory effect on the federal government's ability to assess and collect taxes."[46] Thus, where a party seeks an injunction and declaratory relief, the relief sought is "singular, as equitable relief, and not separate, as an injunction and declaratory judgment."[47] Otherwise, "[a] non-coterminous reading of the two statutes thus poses an insurmountable obstacle. The court would not have jurisdiction to provide declaratory relief but could effectively do so anyway."[48]

Although no court has directly addressed the converse situation—i.e., whether a suit allowed under the Declaratory Judgment Act also allows a court to enter injunctive relief seemingly barred by the Anti-Injunction Act—the rationale in *Cohen* and the result in *Perlowin* support a court's authority to enter injunctive relief in declaratory judgment cases. In such cases, if the court declares that an organization is an organization described in Section 501(c)(3), the court will need to order injunctive relief to restrain the Service from revoking the organization's tax-exempt status. Thus, the relief sought by organizations in declaratory judgment cases is "singular, as equitable relief, and not separate, as an injunction and declaratory judgment."[49]

The Administrative Procedure Act exception to the Anti-Injunction Act. The Administrative Procedure Act, 5 U.S.C. sections 701-708, allows persons "suffering legal wrong because of an agency action" to seek "judicial review."[50] In turn, section 5 of the Administrative Procedure Act states that "[o]n such conditions as may be required and to the extent necessary to prevent irreparable injury, the reviewing court, including the court to which a case may be taken on appeal from or on application for certiorari or other writ to a reviewing court, may issue all necessary and appropriate process to postpone the effective date of an agency action or to preserve status or rights pending conclusion of the review proceedings."[51] Therefore, if the issuance of a FADL would cause the Service to violate its own published administrative procedures, a court may grant relief under the Administrative Procedures Act notwithstanding the general prohibitions of the Anti-Injunction Act.

Suggestions for implementing this strategy

While the strategies discussed in this memo can provide substantial benefits to a multitude of tax-exempt organizations subjected to extremely long

[42] 5 U.S.C. section 705.

[43] 28 U.S.C. section 2201(a).

[44] Cohen, 650 F.3d 717, 727-31, 108 AFTR2d 2011-5046 (D.C. Cir., 2011); Perlowin v. Sassi, 711 F.2d 910, 911, 52 AFTR2d 83-5654 (CA-9, 1983), ("[t]he Declaratory Judgment Act is coextensive with the Anti-Injunction Act despite the broader language of the former. If suit is allowed under the Anti-Injunction Act, it is not barred by the Declaratory Judgment Act").

[45] Cohen, *supra* note 44 at 650 F.3d 730 (internal quotations and citations omitted).

[46] *Id*.

[47] *Id*.

[48] *Id*.

[49] Cohen, *supra* note 44 at 650 F.3d 731 (internal quotations and citations omitted).

[50] 5 U.S.C. section 702.

[51] 5 U.S.C. section 705.

examinations, implementation of these strategies should begin well in advance of filing a petition for a declaratory judgment.

The ultimate success of this strategy requires a demonstration that the organization made a request for determination and that it exhausted all of its administrative remedies within the Service. Therefore, an organization should consider including language in its protest that specifically requests a determination regarding the ongoing recognition of its tax-exempt status. To this end, in addition to requesting a conference with the Appeals Division, a protest to a proposed revocation should state that the organization requests a determination regarding its continued recognition as an organization described in Section 501(c)(3).

Also, to demonstrate the exhaustion of administrative remedies, it is recommended that the organization maintain a record of its efforts to obtain a ruling, including copies of all information provided to the Service after the close of the examination, because such information may not be a part of the administrative record. Additionally, an organization should periodically supplement the administrative record by submitting explanations and documentation demonstrating that the organization's activities are compliant with the Section 501(c)(3) requirements.

With respect to the scope of the court's jurisdiction, it may be beneficial for the organization to file a complete Form 1023 with the Service during the pendency of its administrative appeals process. As previously discussed, Rev. Proc. 2013-9 generally does not permit the Service to make a determination regarding the exempt status of an organization that is subject to an examination or litigation. When litigating the case, however, the court will likely find a written statement from the Service informing the taxpayer that it would not process the Form 1023 to be the most compelling evidence that the Service would not process a Form 1023.

Alternatively, if the Service reviews the Form 1023 and the organization has undertaken the necessary effort to revise its practices in a manner that addresses the concerns raised in the RAR, there will be a substantial likelihood of receiving a successful determination on the application. This will create substantial litigating hazards in the Service's case, and may negate the need for the organization to challenge the Service's proposed revocation.

As a final matter, it is should be noted that the use of this strategy may affect an organization's choice of venue for bringing a declaratory judgment action. Section 7428 confers jurisdictional authority to issue declaratory judgments regarding qualification for Section 501(c)(3) status on the U.S. District Court for the District of Columbia, the U.S. Court of Federal Claims, and the Tax Court. As a practical matter, however, given the *Gladstone* and *Anclote* decisions, the Tax Court offers the most favorable precedent respecting the court's jurisdiction over declaratory judgment cases brought before the issuance of a FADL. Also, the Tax Court may be a better venue for an organization that intends to file a petition in the hope of obtaining a closing agreement. Tax Court cases are tried by the IRS Office of Chief Counsel, while cases in district court and the Court of Federal Claims are tried by the Tax Division of the Department of Justice. In the experience of the author's firm, attorneys from the IRS Office of Chief Counsel often have a better relationship with the Tax-Exempt and Government Entities Division, which may expedite potential settlement discussions.

Conclusion

Through the use of the strategies discussed above, organizations subject to proposed revocations that have taken the necessary steps to address issues raised in the Service's RAR may be able to compel the Service to agree to a quick and non-adverse resolution to the examination. This will add another arrow to the quiver of tax-exempt organizations subjected to unending IRS examinations. ■

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AUTHORS

Matthew T. Journy

George E. Constantine

Jeffrey S. Tenenbaum

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The most aggressive tax-exempt organization enforcement initiative to date has provided lessons to the entire EO community.

In 2003, the Service began a compliance project focused on the entire sector of credit counseling organizations tax-exempt under Section 501(c)(3). The credit counseling compliance project was a huge undertaking which, by some estimates, involved IRS examinations of more than 80% of the industry as measured by revenue. The unprecedented scope of this project—essentially the examination of nearly every organization within a single industry—was matched only by the Service's aggressive posture during the examinations. Unlike previous compliance projects, the Service set out a clear goal for the credit counseling compliance project—to "attack," as the Service put it, the tax-exempt credit counseling industry. On 11/30/03, IRS Commissioner Mark W. Everson testified before the U.S. House of Representatives Committee on Ways and Means. In response to a question on the portion of the industry the Service had "under audit," Commissioner Everson said, "we are actually attacking 40 percent of it."

Over the last six years, as announced on 6/23/09 by Commissioner Sarah Hall Ingram, the Service "examined virtually every credit counseling organization in the country, and revoked the tax-exemption of over 40 percent of the industry, as measured by revenues."

While the credit counseling compliance project was unique with regard to its scope and the Service's extremely aggressive position, the lessons learned from this process can be used to help tax-exempt organizations—particularly those exempt under Section 501(c)(3)—better understand the focus of the Service's future examinations. These lessons contain guidance on how to prepare for future examinations, what an organization should do when it is informed of an impending examination, what to do during an examination, and what to do if an examination results in an adverse determination.

Background

Tax-exempt status is highly valued, and not just because it allows an organization to receive related income without being subject to taxation. There are other, substantial benefits, including exemption from certain statutory requirements, that go along with exempt status (particularly for organizations exempt under Section 501(c)(3), which also can receive tax-deductible contributions). In exchange for these benefits, exempt organizations have a number of organizational and operational obligations they must meet.

As a result of these additional benefits and responsibilities, the scope and consequences of exempt organization examinations are drastically different from examinations of taxable corporations. As such, an exempt organization executive needs to understand that the consequences of an adverse determination include not merely additional tax and penalties; there is also revocation, a result that can be the death of the organization. Both because the credit counseling audits involved Section 501(c)(3) organizations and because the requirements and the costs of revocation are highest under that section, this article focuses on organizations that are tax-exempt under that section.

Section 501(c)(3) requirements

As mentioned above, unlike their taxable counterparts, tax-exempt organizations are subject to multiple organizational and operational requirements. As such, examinations of tax-exempt organizations are not merely financial audits; they are comprehensive reviews of the organizations' governance, operation, management, activities, and methodologies to ensure compliance with each of the substantial requirements for qualification. Therefore, any review of examinations of exempt organizations must begin with a description of the requirements for exemption.

General Section 501(c)(3) issues. In general, for an organization to qualify as exempt under Section 501(c)(3), it must pass both the "organizational" and "operational" tests set forth in the Code and accompanying regulations. As such, the organization must demonstrate that it is both "organized" for a qualifying purpose or purposes and that it is "operated" for the furtherance of such purpose or purposes.

In determining whether the "organizational" test is met for a particular organization, the Service generally looks to governing documents. If an organization's articles of incorporation and bylaws are consistent with the requirements and identify one or more qualifying exempt purposes, the organizational test usually is deemed to have been met. Qualifying exempt purposes for Section 501(c)(3) are those that are scientific, educational, charitable, religious, testing for public safety, and literary. [1]

The "operational" test is more involved and more subjective than the "organizational" test. In general, the Service will consider the full scope of an organization's activities to ascertain whether, in practice, the organization is fulfilling its stated mission and whether any substantial part of the organization's activities is for a non-exempt purpose. A non-exempt purpose is generally one that serves a private interest rather than a public interest. Therefore, this is often described as a "private benefit." The presence of a private benefit, if substantial in nature, will destroy an organization's exemption, regardless of an organization's other charitable purpose or activities. A private benefit can disqualify an organization if the benefit flows to individuals or entities closely related to the organization as well as disinterested third parties.

In *Better Business Bureau of Washington D.C., Inc.*, 34 AFTR 5, 326 US 279, 90 L Ed 67, 1945 CB 375 (1945), the U.S. Supreme Court held that the presence of a single non-exempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly exempt purposes. The Court found that the trade association had an "underlying commercial motive" that distinguished its educational program from that carried out by a university.

Similarly, in *American Institute for Economic Research*, 9 AFTR 2d 1426, 157 Ct Cl 548, 302 F2d 934, 62-1 USTC ¶9466 (Ct. Cl., 1962), the Court of Claims considered the status of an organization that provided analyses of securities and industries and of the economic climate in general. The organization sold subscriptions to various periodicals and services providing advice for purchases of individual securities. Although the court noted that education is a broad concept, and assumed for the sake of argument that the organization had an educational purpose, it held that the organization had a significant non-exempt commercial purpose that was not incidental to the educational purpose and was not entitled to be regarded as exempt.

In light of these requirements, one of the first things the Service will look to in an examination is not a statement of revenues and expenses, but an organization's actual operations. During the course of tax-exempt organizations' examinations, it is not unusual for agents to review the minutes from meetings of an organization's governing body, review employee training manuals or handbooks, and even attend organization programs. As such, it is imperative that every exempt organization documents how each of its activities, from training employees to holding fundraisers, furthers the organization's exempt mission, and ensures that all of its materials—both public and internal—are consistent with its mission.

Private inurement. Another limitation for Section 501(c)(3) organizations is that such organizations are prohibited from entering into transactions that result in "private inurement." Generally, a transaction between a tax-exempt organization and an "insider" (i.e., someone able to exert substantial influence over the tax-exempt organization or someone with a close relationship to such an individual) will result in private inurement if it results in greater than fair market value or unreasonable return benefit being paid to the "insider." If the Service determines that a tax-exempt organization's assets inured to the benefit of an insider, the Service has the authority to revoke the organization's exempt status.

Note that private inurement is generally considered to be separate from the larger concept of "private benefit," discussed above. While private benefit may exist when the activities of an organization confer a more than insubstantial benefit on either insiders or disinterested third parties, private inurement is specifically tied to those closely related to the organization and usually involves pecuniary benefits.

In analyzing the private inurement issue, the Service will frequently review whether the organization has a conflict of interest policy and whether the organization entered into any transactions with entities controlled by the organization's insiders. Further, the Service likely will do a substantive analysis of the agreements between the organization and its insiders, including employment agreements, to determine reasonableness. Once again, this issue goes much deeper than the mere reconciliation of income and expenses that characterizes most examinations of taxable organizations.

Intermediate sanctions. In addition to the private inurement proscription, the Code allows the Service to levy excise taxes (referred to commonly as “intermediate sanctions”) against certain individuals and private entities that receive better-than-fair-market-value in transactions with Section 501(c)(3) and 501 (c)(4) organizations. [2] In practice, the Code's proscription of private inurement and its intermediate sanctions provisions are focused on the same type of activity—transactions that provide excessive benefit to an individual or an entity that has the ability to exert substantial influence over the tax-exempt organization, or to those that are closely connected to such an individual or entity.

An important distinction between the two doctrines concerns the type of sanctions allowed. Under the private inurement provisions, only the tax-exempt organization may be penalized and the sole penalty available is revocation of exempt status. By contrast, the Service may use the intermediate sanctions provisions to impose excise taxes on the individual or entity that benefited from the better-than-fair-market-value transaction, as well as on the individual exempt organization managers who knowingly approved the transactions. [3]

Certain individuals (referred to in the intermediate sanctions provisions as “disqualified persons”) who benefit from excess benefit transactions must repay to the tax-exempt organization the full amount of the excess benefit. Additionally, the disqualified person may be subject to an initial excise tax equal to 25% of the amount of the excess benefit. Also, the Service may impose an excise tax of 10% of the excess benefit on the organization's managers who approved the transaction, including members of the board of directors. If a disqualified person fails to repay the amount of the excess benefit before a tax is assessed or a notice of deficiency is issued, the Service may impose an additional excise tax of up to 200% of the excess benefit on the disqualified person.

For purposes of Section 4958, a “disqualified person” is any person who is (or has been within the previous five years) in a position to exercise substantial influence over the tax-exempt organization. Among the facts and circumstances that the Service will consider as tending to reflect that a person or entity has substantial influence over the affairs of an organization are (1) the person holds a position of authority within the organization (e.g., a director or officer), (2) the person or entity's compensation is based on revenues derived from activities of the organization, and (3) the person or entity manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization as a whole. [4]

For a transaction to result in excess benefit, it must be one for which the tax-exempt organization paid more than fair market value. Treasury regulations implementing the intermediate sanctions set out a three-step process for an exempt organization to use in establishing a “rebuttable presumption” that a particular transaction was reasonable (i.e., not excessive). That process is: (1) have the transaction considered in advance by a body of disinterested decision-makers (at a time when the disqualified person is not part of the decision-making); (2) have the decision-making body rely on appropriate, reliable comparability data (such as independent surveys) when deciding whether a contemplated transaction is at fair market value; and (3) have the fact of the decision, the identity of the decision-makers, and the basis for the decision contemporaneously documented. While this process is not mandatory, it shifts the burden of proof to the Service to demonstrate that the transaction involves an excess benefit, provides credible and contemporaneous evidence that the organization sought to ensure the transaction was appropriate, and generally helps ensure that the transaction is fair to the organization regardless of whether the IRS ever reviews it.

In making determinations with respect to whether a benefit resulted in an excessive benefit, the Service will consider each transaction with one or more disqualified persons, including the procedure that the organization used to approve it. The authors have most often seen this issue come up with respect to the payment of excessive compensation, but it is not uncommon to see it when the organization buys property from a disqualified person or enters into a service contract with an entity owned or controlled by a disqualified person.

Unrelated business income tax. An exempt organization is not taxed on its income from an activity that is substantially related to the charitable, educational, or other purpose that is the basis for the organization's exemption. Such income is exempt even if the activity is a trade or business. However, if an exempt organization regularly carries on a trade or business that is not substantially related to its exempt purpose, the organization is generally subject to tax on its income from that unrelated trade or business.

Unrelated business income is income (1) from a trade or business (2) that is regularly carried on by an exempt organization and (3) is not substantially related to the performance by the organization of its exempt purpose or function. While beyond the scope of this article, there is a rich body of guidance on the meaning of each of these criteria, as well as numerous exceptions.

In general, if the Service finds that an exempt organization is subject to UBIT, the consequence is not a denial or revocation of the organization's exempt status. Rather, the organization will be subject to tax only on the unrelated business income. However, depending on the circumstances and the scope of how the Service defines the criteria as applied to an exempt organization, the tax owed on the unrelated business income could be significant.

Liability for UBIT will not automatically jeopardize an organization's tax-exempt status. However, to the extent that a substantial portion of an organization's activities are unrelated to its tax-exempt purpose, the organization may be jeopardizing its tax-exempt status regardless of whether it pays tax on the unrelated income.

Focus and trends in IRS examinations

As mentioned above, unlike examinations of taxable entities, the primary focus of examinations of tax-exempt organizations is on the organizations' operations. As such, during an examination, the Service will review an organization's activities, relationships, and governance to ensure that all such activities further an exempt mission and that none of the organization's programs further a substantial non-exempt purpose or provide an impermissible benefit.

Traditionally, examinations of tax-exempt organizations have focused primarily on organization activities, and the Service has developed cases for revocation for engaging in activities that do not further an exempt purpose or for providing private benefit or private inurement. In developing these cases in the past, the Service has largely ignored the intermediate sanctions provisions that, as discussed above, allow the Service to impose substantial pecuniary penalties on individuals who are able to influence the activities of the organization to receive excessive benefits and on individuals who approve such benefits.

Recently, however, the Service has become more aggressive in pursuing revocations of exempt status. In addition to the activist statements referenced at the beginning of this article regarding the credit counseling industry, the authors have participated in a number of informal conversations with revenue agents and others in the Service. These conversations reinforce the perception that the Service has taken a sharp move away from seeking to achieve mutually agreeable results in exempt organization examinations.

Further, recent activities by the Service suggest that it has begun to use the intermediate sanctions far more frequently than ever before. It is not an exaggeration to say that in the last year, the authors have seen the Service assess intermediate sanctions in more examinations than in the previous five years combined. The manner in which the Service has assessed the penalties is also unique. Previously, the Service seemed to focus its efforts on developing cases with obviously excessive benefits and proposed intermediate sanctions in lieu of revocation. In the last year, however, the authors have seen the Service impose intermediate sanctions with more aggression, proposing assessment in situations where the amount of the excessive benefit is minimal and even imposing intermediate sanctions in addition to revocation. Not only is this new approach being used to develop cases during examinations, it is also supported by the Office of Chief Counsel of the IRS. During a recent conversation with an attorney at Counsel's office, the authors were told that the Service is developing cases for intermediate sanctions and that it will pursue these cases aggressively in court.

With this new IRS posture, organizations need to be aware of the potential risks and act accordingly, particularly with regard to potential private inurement and intermediate sanctions matters. Additionally, organizations still need to be aware of the more traditional issues, such as engaging in substantial nonexempt activities or providing impermissible private benefit. Especially in this more aggressive enforcement environment, organizations cannot wait until the Service appears to clean up any existing exemption or intermediate sanctions issues.

Types of examinations

The Service conducts several types of examinations. Two of the types of examinations the authors have

seen most frequently in the world of tax-exempt organizations are correspondence examinations and field examinations.

Correspondence examinations

Correspondence examinations are what the name implies—examinations in which an organization responds to requests made by the Service through letter, fax, or email. [5] Correspondence examinations generally are used for smaller organizations and are limited to a review of a particular issue. In some situations, a correspondence examination will be converted to a field examination.

Correspondence examinations serve many purposes. First, correspondence examinations allow the Service to review the activities of many organizations quickly, limiting the the burden on the Service's resources. Also, because of their limited focus, correspondence examinations allow the Service to conduct a widespread review of a particular issue in an entire industry, or statistically valid sample of organizations in a given industry, all at once.

An organization subject to a correspondence examination will be alerted by a letter from the IRS informing it of the examination and requesting information pertaining to the issue being examined. Based on the information provided, the Service will make a determination regarding the issue under review, request additional information, or convert the examination to a more intrusive field examination.

When an organization receives notification of its correspondence examination, it is important that the organization respond quickly and completely. First, a complete failure to respond frequently will draw even sharper attention from the Service. Second, sending the Service disorganized, incomplete, or inadequate information may increase the likelihood of the Service determining that it needs to convert the examination to a field examination.

Field examinations

Field examinations are what people usually think about when they think of IRS examinations. They begin with a notification from the IRS that it is going to conduct an examination of the organization's activities during a particular period. The notice will include a proposed date for an office visit by the agent conducting the examination. In addition to the office visit, the Service will provide an initial Information Document Request (IDR) setting forth the initial documents and other information the Service is seeking from the organization. Unlike correspondence examinations, field examinations are often burdensome, intrusive, and slow moving.

During a field examination, an IRS revenue agent will be on site reviewing the information provided and interviewing individuals who have knowledge about the organization's operations. Further, the substantial amount of information requested in the initial IDR is itself a burden. While every examination is unique, the initial IDRs sent during examinations of credit counseling agencies would frequently request information and explanations of more than 50 items, including such items as all minutes for meetings of the governing board for three tax years, copies of all third-party service agreements, and copies of all bank statements during the periods under examination. In one examination that the authors worked on, the information requested by the initial IDR filled more than 40 boxes. In addition to the work and effort required to assemble and copy all of this information, most agents would like to review the information on site, sometimes requiring multiple weeks at an organization's offices. Also, as the agents review the information, they likely will have questions and need to interview various employees about the information provided in response to the IDR. Finally, the initial IDR is rarely, if ever, the Service's last request for information and the agent's initial visit to the organization's offices is rarely his or her last.

While the nature of the examination causes field examinations to be burdensome, the breadth of the information reviewed causes them to be long and slow moving. During the examination that began with the 40-box response to the initial IDR, the Service issued more than a dozen additional requests for information during the course of its examination. While that is an extreme example, it is no wonder that IRS examinations can take in excess of two years to reach a proposed resolution when one considers the amount of time required by organizations to gather, organize, and copy all of the information requested; the amount of time required by the agent to review all of this information, interview the organization's employees about the information, and prepare additional requests for information; and then the time required to repeat the process several times. If the proposed resolution is anything other than a no-change letter (described below), further discussions between the organization and the Service likely will consume even more time.

Potential outcomes

There are four potential outcomes of an IRS examination of a tax-exempt organization—a no-change letter, a no-change letter with written advisories, a closing agreement, and a revocation.

No-change letter

A no-change letter is the best result of an examination of a tax-exempt entity. Essentially, a no-change letter informs the organization that the Service found no issues during its examination and has determined that the organization properly completed its annual Forms 990. As such, the Service recommends no changes to the examined Form 990.

No-change letter with written advisories

A no-change letter with written advisories is the second best result. Such a letter informs the organization that, while it is generally acting in accordance with the requirements of Section 501(c)(3), the examination uncovered one or more minor issues that, while worth mentioning, are not substantial enough to result in a revocation.

The no-change portion of the letter indicates that the organization will continue to be recognized as a tax-exempt organization without need for revision to the examined Form 990. The advisories portion of the letter provides the organization with a description of the issues (such as the failure to maintain adequate records) that the Service found and informs the organization of the consequences of failing to comply with such requirements in the future. In the event of a subsequent examination of an organization that received a no-change letter with written advisory, it is almost certain that the Service would look closely at those areas identified in the advisory portion to determine whether the organization made changes to its operations. Still, the advisory technically carries with it no formal enforcement mechanism (although the authors have been told that the Service has a process in place to monitor compliance with advisories).

Closing agreement

A closing agreement is an agreement with the Service under which it agrees to continue recognizing the tax-exempt status of an organization and the organization agrees to (1) act in accordance with specific guidelines required by the IRS and (2) possibly pay a stated penalty amount (generally considered a payment in lieu of tax). A closing agreement is not the most favorable resolution to an examination because it frequently requires payment of a pecuniary penalty. It does, however, allow an organization to retain its tax-exempt status.

Closing agreements generally are appropriate when an organization was engaged in noncompliant activities but, prior to the close of the examination, ceased such activities. In these situations, the Service will frequently agree to continue to recognize the organization's tax-exempt status if the organization agrees to sign an agreement stating that it will no longer engage in specified activities and will pay tax on the revenue derived from such activities. Such documents have often also included an agreement by the organization to implement certain procedures to prevent future problems. In practice, the Service has moved away from offering closing agreements, primarily due to the significant procedural hurdles that it must overcome to get them approved internally.

Revocation

A revocation letter is the worst possible outcome. Upon receiving a final revocation, the organization is no longer recognized as a tax-exempt organization as of the date specified in the letter. Based on the information provided in the letter, an organization may have to go back and re-file tax returns for prior years as a taxable entity (and pay any accompanying tax liabilities, plus interest and penalties). As detailed below, however, the Service will first issue a proposed revocation letter and allow the organization a chance to respond before finalizing the revocation.

Dealing with the IRS

Dealing with an IRS examination is an extended process. It requires a commitment to meeting the requirements for tax-exempt status prior to the examination and working with the Service during the examination to show why the organization should remain exempt.

Prior to an examination

In almost every examination on which the authors have worked, all of the issues raised by the Service could have been easily addressed prior to the examination by developing adequate governance and policies, avoiding certain activities, and doing a better job at making sure annual filings were timely and accurate. The examinations in which the IRS raised few, if any, issues were examinations of

organizations that generally had taken the appropriate precautions years before.

Governance and policies. Many of the common problems discovered during examinations could or should have been addressed by better governance. For instance, many issues relating to excessive compensation could have been addressed through the implementation of an appropriate compensation approval policy (one that, at a minimum, incorporated the rebuttable presumption process provided in the intermediate sanctions regulations, at least with respect to disqualified persons). In an examination of an exempt organization, the Service invariably will request the compensation approval policy, as well as an explanation of the organization's compensation approval process. Not only will the implementation of such a policy help the organization avoid potential issues relating to the amount of compensation that it provides, but providing the Service with a copy of the policy sets a positive tone for the Service's compensation review. In general, the Service is far less likely to challenge a compensation level for an executive if a solid policy was followed by the organization in arriving at that level than it would if there were no such policy or procedures in place.

Additional policies that can benefit the organization during an examination include a conflict of interest policy, a document retention policy, a public disclosure policy, and a whistle-blower protection policy. Moreover, the organization should have an independent board of directors that monitors and documents its compliance with each of these policies. The Service has published a list of its preferred policies in the tax-exempt organization portion of its Web site. [6] By developing and implementing policies that conform to the Service's preferences, organizations can demonstrate that, to the extent their activities comply with these policies, their activities are in compliance with the requirements of Section 501(c)(3).

Activities. On Form 1023, "Application for Recognition of Tax Exempt Status Under Section 501(c)(3)," every tax-exempt organization provides the Service with a description of its activities and its tax-exempt purpose(s). The surest way for an organization to avoid issues regarding its activities is to comport its activities in accordance with the information disclosed on its Form 1023. Also, when the organization undertakes new activities, it is important to document how those activities further the organization's tax-exempt mission, as well as to report such new activities on the organization's annual Form 990.

Annual reporting. The most important annual IRS reporting requirement is Form 990. Through Form 990, organizations must report information about their activities, governing body, executive compensation, revenue sources, a breakdown of the types of expenses they incur, a description of how their major activities accomplish the exempt mission, and a description of transactions with related parties. Also, the Form 990 is subject to public disclosure, meaning that this substantial amount of information is available to the Service, the media, and the general public (through resources such as the Guidestar Web site). As such, it is imperative for organizations to complete Form 990 as completely and as accurately as possible. Misinformation, incomplete information, or information presented in a manner that does not favorably portray the organization's activities can attract the Service's attention, as well as adverse media or public scrutiny.

During an examination

While many of the issues pertaining to IRS examinations can and should be addressed prior to the examination, the most import part of the process is obviously the examination itself. The actual examination can be as short as a few months or as long as five or more years.

Notification and response to initial IDR. As discussed above, the examination will begin with the notification and the initial IDR. The notification will likely include a proposed date for the initial visit, and the initial IDR will include a due date. Organizations must understand that these are proposed dates. It is far more important for an organization to be prepared than to be quick. If the proposed date of the initial visit is two weeks from the receipt of the initial IDR and the organization cannot be prepared in time, it should call the agent and reschedule the initial visit. In the authors' experience, agents do not like to significantly delay initial visits or the due dates for IDR responses, but most understand that they are requesting a significant amount of information and that organizations need time to assemble it.

Also, the authors have found that a thorough, well-organized response to the initial IDR is the best way to set a positive tone for an examination. In most examinations, the response to the initial IDR is incomplete and disorganized. Not only does this fail to accomplish the goal of demonstrating the organization's compliance, it also creates more work for the agent and sets an adversarial tone from the outset. If the initial response to the examination is thorough and well organized, however, the agents will recognize that the organization is making an effort and will be willing to work with it as issues arise

during the course of the examination. This relationship with the agent is an important, though often overlooked, aspect of the examination.

While an examination is very much focused on facts and documents, a substantial basis for the outcome of the examination is statements, explanations, and interpretations. If an organization has a good relationship with the agent, its statements and explanation are more likely to be given weight by the agent and the agent's interpretations of facts likely will be more favorable to the organization. This is just one of the many reasons that the authors recommend providing a complete and well-organized response to every IDR. It also is another reason for requesting additional time to respond to information requests early. Many organizations believe that the more quickly they respond to requests from the agent, the more quickly the examination will be completed. It is true that if the organization does not substantially delay its responses to the Service, its portion of the examination will be quicker. Still, the Service frequently moves at its own pace, and the speed with which the organization provides information to the Service has very little impact on the overall pace of the examination. Additionally, a rushed response to an IDR frequently has errors or omissions that can result in additional requests for information and additional delays.

Finally, when responding to the initial IDR, it is important to respond to each request. The authors find it is most helpful to mimic the organization of the IDR in an organization's responses. For instance, if questions are ordered by numbers, responses should be as well. Also, the organization should include a well-crafted narrative explanation of the information provided in response to each request. This makes it possible to explain how each document provided to the Service demonstrates compliance with the requirements of Section 501(c)(3). For instance, do not simply give the Service a copy of a 200-page employee manual and hope that the agent focuses on the best parts of the employee training program. Rather, give the Service the employee training manual with an explanation about how the training program discussed on thus-and-such pages focuses on developing the specific skills needed to serve the community in accordance with the organization's exempt mission.

By providing a thorough and organized response to the initial IDR request, the organization can set the appropriate tone for the rest of the examination. For this reason, it is also generally advisable to involve outside experts at the outset. One common source of trouble in examinations is delegating the preparation of IDR responses to employees with no particular knowledge of the exempt organization requirements, particularly if that employee must continue to cope with his or her other duties. This can result in a late, incomplete, disorganized response, and sometimes an actually harmful one (e.g., one that discloses problematic activity with no explanation or corrective plan).

Interviews. The agent probably will need to interview certain employees and organization executives during the course of the examination. One of the most important things to understand about interviews is that they provide a context and further explanation of information already provided to the Service. The focus of the interviews will likely be tied to specific information that the Service wants to know, such as why a particular process is used or how it furthers the organization's exempt mission. With this in mind, the interviewee should limit the information discussed during the interview to only the information asked for by the agent. Also, it is acceptable to ask to see the information referred to in the question. Finally, people should only answer questions to which they know the answer. Answers such as, “no,” “I don't know,” and “I need to look into that” are frequently the best answers. If at all possible, organizations should arrange for legal counsel and/or other tax advisors with exempt organizations expertise to both prepare interviewees and to be present for interviews.

Requests to extend the statute of limitations. As mentioned above, examinations can take years. As such, during the course of an examination, many organizations will receive a Form 872, "Consent to Extend the Time to Assess Tax." An organization is not required to sign the Form 872, but if it does not, the Internal Revenue Manual—the Service's internal procedure manual—requires agents to issue a 90-day letter revoking the organization's tax-exempt status, cutting short an organization's procedural rights within the Service and forcing it either to accept the revocation or pursue a challenge (post-revocation) in federal court. Therefore, it is often advisable to sign an extension form.

After an examination

Upon completion of the examination, assuming no closing agreement has been reached, the Service will issue one of three letters—a no-change letter, a no-change letter with advisories, or a proposed revocation letter. If the organization receives a no-change letter, the examination is complete and the organization will continue to be recognized as exempt. In such situations, the organization need only

keep up the good work.

If the organization receives a no-change letter with advisories, the examination is complete and the organization will continue to be recognized as exempt prospectively. However, the Service's recognition of the organization's tax-exempt status will be based on the condition that it agrees to the follow the advisories issued by the Service. In such situations, the organization needs to keep up the good work and follow the advisories (and document that they have been followed).

The worst result at this stage in the audit is the proposed revocation. A proposed revocation is not a final determination, however, and has no immediate impact on an organization's tax-exempt status. [7] A proposed revocation is merely the Service's position based on the information it reviewed during the course of the examination. At this point, the organization will have 30 days (or longer if an extension is negotiated) to “protest” the proposed ruling and avail itself of the IRS appeals process, a process that itself could take several more years. During the pendency of the appeal, the organization would remain tax-exempt.

It is important for organizations to understand that a proposed revocation is not a final ruling. The authors represent several clients that each received a proposed revocation, only to have the Appeals Division of the IRS overturn the proposed revocation and recognize the organization as exempt. Additionally, the authors have represented many organizations that received their proposed revocation letters more than five years ago without ever receiving final adverse determinations.

Conclusion

IRS examinations can be intimidating, especially for tax-exempt organizations that are subject to extremely invasive procedures. However, proper preparation prior to the examination coupled with an organized presentation of information during the examination can produce a successful result and a relatively painless experience.

__MATTHEW T. JOURNY__ is an associate, and __GEORGE E. CONSTANTINE__ and __JEFFREY S. TENENBAUM__ are partners, in the Nonprofit Organizations Practice of the Venable LLP law firm, based in Washington, DC. They can be reached at 202-344-4000 or at __mtjourny@venable.com__, __geconstantine@venable.com__, or __jstenenbaum@venable.com__.

[1] See Section 501(c)(3) generally; note that other potentially qualifying purposes not relevant to this review also exist.

[2] See generally Section 4958.

[3] Representatives of the Service, speaking informally, have stated that the Service may consider not only compensation paid directly to an individual from the exempt organization, but also compensation received indirectly through related organizations for purposes of evaluating whether such individual received total compensation in excess of fair market value. The Service generally will take such an approach only when the indirect compensation is paid by an entity that is supported solely by revenue paid by the exempt organization.

[4] There is an “initial contract” exception to the facts-and-circumstances test. Specifically, Reg. 53.4958-4(a)(3) provides that intermediate sanctions generally will not apply to payments made pursuant to a binding written contract between an applicable tax-exempt organization and a person who was *not* a disqualified person immediately prior to entering into the contract.

[5] Reg. 601.105(b)(2).

[6] See **www.irs.gov/pub/irs-tege/governance_practices.pdf**.

[7] While a proposed revocation has no immediate impact on an organization's tax-exempt status, it may result in nontax reporting issues including financial statements, bond disclosures, or state reporting requirements.

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