

IRS Exams and Revocation of Tax-Exempt Status—What Nonprofits Need to Know and How to Be Prepared

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Today's Discussion

Exams in Context—Who gets selected and how?

Common Issues in Exams

Types of Exams

Examination Process

Options to Appeal Adverse Determinations

Effects of Revocation of Tax-exempt Status

How to Prepare

How Organizations Are Selected for Examination

Compliance strategies:

- IRS initiatives targeting specific areas of concern
- TE/GE exempt organizations work plan for FY25 is focused on Form 990N filers; excise taxes on excess compensation under IRC §4960; tax-exempt hospitals; and tax-exempt collectives using name, image, and likeness (NIL) agreements with student athletes

Referrals, claims, other casework:

- Complaints or referrals can come from the public, government agencies, or other sources
- Form 13909—Tax-Exempt Organization Complaint (Referral)

Data-driven approaches

- Information flagged from Forms 990
- Inconsistent or incomplete information in a filed return
- Financial irregularities or discrepancies, unreasonable compensation, excess benefit transactions, diverted assets, substantial unrelated business income

IRS Exams—Recent Statistics

In FY 2023:

- 2,529 exams started (232 compliance strategies; 790 data-driven; 1,507 referrals, claims and other casework)
- 2,464 exams closed (221 compliance strategies; 746 data-driven; 1,497 referrals, claims and other casework)
- 141 revocations
 - 124—operational requirements
 - 26—filing requirements
 - 16—organizational requirements
 - 16—unrelated business income
 - 9—Chapter 42 taxes (private foundation excise taxes)
- 541 Exempt Organizations Division employees

IRS Compliance Projects

IRS compliance projects have focused on:

- Colleges and universities
- Hospitals
- Credit counseling organizations
- Housing counseling and foreclosure prevention

Typically begin with a questionnaire and lead to IRS exams

Common Issues in Exams

Organizational and operational requirements

- Substantial non-exempt purposes or activities
- Private inurement or private benefit
- Lobbying and political activities

Unrelated business income

Executive compensation

Employment taxes

Less common: illegality, violation of established public policy

Types of Examinations

Correspondence
Examinations

Field
Examinations

Correspondence Exams

Conducted by letter—fax or mail

Used for exams in which the taxpayer can readily mail information to resolve any questionable issues

- Smaller organizations
- Discrete issues
- Initial stage of compliance projects

Examiners may consider complexity of taxpayer's books and records, geographical location, staff availability, and resources when choosing between correspondence and field exam

Exam can begin as a correspondence exam and later be converted to a field exam

Field Exams

Field exams involve on-site visits by the examiner to:

- Review specific information on-site (requested in advance)
- Interview individuals with knowledge about the requested information
- Tour offices

An on-site visit is typically at the taxpayer's principal place of business but can be at a taxpayer representative's office; can take place over multiple days

Additional follow-up visits, interviews, and document requests are possible as examiner works through the exam

The examination process can take anywhere from several months to several years—after providing all information and completing site visits and interviews, examiners can take considerable time reviewing, analyzing, and making determinations

Examination Process

Notification Letter

Exam begins with a notification letter sent by the examiner responsible for the examination

Provides the name, ID number, and contact information for the examiner

Includes a proposed date for the initial visit by the examiner

- You should reach out to tax preparer, counsel upon receipt of the notification letter
- If the proposed date is bad for you or your organization, have your representative call the examiner and request a new date and time

Examination Process

Information Document Request

Initial IDR is typically attached to the Notification

Includes a proposed due date—if you need more time, ask for it

Initial IDR will request a substantial amount of information about the tax period under examination

- The IRS has very broad discretion in reviewing information during exams, but consider working with your rep to negotiate the scope of the IDR to narrow issues

To the extent possible, provide all of the requested information in an organized manner, but don't provide information that is not requested; if you have information that you want to provide that is not requested, ask the agent to provide an additional IDR requesting such information

Review documents thoroughly before providing and withhold any documents that may be privileged

Examination Process

Information Document Request

Typical documents requested:

- Articles of incorporation, bylaws, and any amendments
- Application for tax-exempt status and IRS determination letter
- All filed Forms 990 and documents supporting the figures and information reported
- Financial statements prepared by any external auditor
- Financial records (journal, ledgers, bank statements, etc.)
- Board meeting minutes
- Printed material and literature the organization distributes about its programs and activities
- Conflict of interest policy and associated disclosure forms
- Documents related to employment tax matters, including Forms W-2 and 1099

Examination Process

Initial Visit

Try to have as much of the requested information available to the examiner for review at the initial visit

Have a meeting with the examiner prior to their review of documents so that you can explain the information provided in response to the IDR; have your advisor(s) present

Have a copy of all of the information provided to the examiner

Each examiner is different—some will want to discuss the information in depth and others will simply read the information behind closed doors

Examination Process

Initial Visit

Provide the agent with space to work separate from other staff that is quiet and comfortable (e.g., a conference room or empty office)

Note that the IRM permits a taxpayer to have the field examination conducted at the taxpayer representative's office in lieu of it occurring at the taxpayer site

Ideally, have legal counsel or other tax advisors retained to assist with the exam prepare the interviewees and be present for all interviews

Examination Process

Common Mistakes

Providing a rushed response

Failing to provide all of the requested information

Providing the information in an unorganized manner

Being combative

Sharing more than necessary, more than asked

Examination Process

Subsequent IDRs

- Expect subsequent IDRs; there are always unresolved issues
- The subsequent IDRs will likely give an indication of the examiner's plan

Requests for Extensions of the Statute of Limitations, Form 872

- Consult counsel, but it is often advisable to sign these when requested
- Failure to sign the Form 872 may result in accelerated revocation of the organization's exempt status and prompt a notice of deficiency

Potential Outcomes

No Change	No Change with Advisories	Closing Agreement	Revocation
<ul style="list-style-type: none">• Organization continues to be exempt• Exam closes	<ul style="list-style-type: none">• Organization continues to be exempt• In an attached addendum, IRS will provide the organization with a list of advisories that will tell the organization how to conduct its affairs in the future	<ul style="list-style-type: none">• Organization continues to be exempt• Agreement will likely provide the organization with specific requirements for continued recognition and possibly require payment of a tax or penalty	<ul style="list-style-type: none">• Organization will no longer be recognized as exempt• Revocation will be effective as of the date provided in the final letter, unless organization appeals

Closing Agreements

Generally appropriate when an organization has engaged in noncompliant activities but has ceased those activities prior to the close of the examination

Typically requires the organization to agree to act in accordance with specific guidelines and pay a penalty (generally considered a payment in lieu of tax)

These are contracts between the organization and the IRS—failure to comply will likely result in revocation

Adverse Determination—Revocation

Prior to Close of Examination

Closing conference

- Examiner may inform the organization of their intention to propose revocation and give you the opportunity to dispute the factual basis for the proposed ruling in a closing conference

Examiner may also provide a draft proposed revocation letter for the organization to review and dispute any factual errors

Adverse Determination—Revocation

Proposed Revocation Letter—the 30-day Letter

The proposed revocation letter will provide you with the position of the IRS on revocation and the opportunity to dispute the proposed ruling through the IRS Independent Office of Appeals

You have 30 days to protest (appeal) the proposed ruling, unless the examiner provides you with an extension

If you do not agree with the proposed revocation, file a protest

Proposed revocation is **not** a final determination unless the organization accepts the ruling and does not protest it

Upon receipt of the protest, the examiner will transfer the case to the Appeals Division

Adverse Determination—Revocation

IRS Appeals Process

The organization will have a right to a conference with an Appeals Officer who is independent of the IRS examination

Throughout this process, the organization will continue to be recognized as an exempt organization

Based on the information provided in the administrative record, the proposed revocation, and the protest, the Appeals Officer will make a determination on the case

The appeals process can take considerable time (years)

Adverse Determination—Revocation

IRS Appeals Outcomes

If the Appeals Officer agrees with the organization, they can:

- Send the case back to the examiner for additional factual development or to issue a no change letter or
- Enter into a closing agreement

If the Appeals Officer agrees with the examiner, they will issue a final adverse determination letter—the 90-Day Letter—which will revoke the organization’s tax-exempt status

Adverse Determination—Revocation

90-day Letter

Upon receipt of the 90-Day Letter, the organization's tax-exempt status is revoked as of the effective date of revocation specified in the letter

At this point, the organization has exhausted its administrative remedies within the IRS

It will have 90 days within which to file a petition for declaratory judgment with respect to its tax-exempt status in federal court

Petition for Declaratory Judgment

Within 90 days of receiving a final adverse determination from the IRS, the organization may petition for a declaratory judgment on the organization's revocation in:

- U.S. Tax Court
- U.S. Court of Federal Claims or
- U.S. District Court for the District of Columbia

If the initial lower court petition is adverse to the organization, it may further appeal the decision to higher federal courts, as appropriate to its choice of initial lower court

The organization remains revoked during the declaratory judgment process

Effects of Revocation

Organization is treated as a taxable corporation

- File Form 1120—U.S. Corporation Income Tax Return
- Pay tax on net income
 - Amount of tax owed depends on amount of taxable income in a given year and amount of available deductions and credits available (e.g., for ordinary and necessary business expenses, depreciation, etc.)
 - Gifts are not taxable income under Section 102(a) of the Code

Potential loss of state and local exemptions for income, franchise, sales and use, and property taxes if tied to federal tax-exempt status (particularly for 501(c)(3) exempt-organizations)

Effects of Revocation

Loss of 501(c)(3) tax-exempt status results in fundraising challenges

- Cannot receive tax-deductible contributions
- May no longer be eligible for funding opportunities available only to 501(c)(3) public charities from government grants, the private sector, or private foundations
- Private foundation donors would need to make “expenditure responsibility” grants

Preparing for an Examination

The best time to prepare is before an examination begins

Understand the requirements for IRS recognition of your organization's tax-exempt status and review operations for compliance

Ensure records that may be needed for an exam are available and well organized and ensure records retention policy is being followed

Ensure the Form 990 and all other required tax filings are complete and filed in a timely manner

Work with experienced counsel and tax advisors; consider conducting a “mock” audit

Questions?



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