THE IRS TAX-EXEMPT EXAMINATION PROCESS

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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

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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 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.*, 326 U.S. 279, 34 AFTR 5 (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*, 302 F.2d 934, 9 AFTR2d 1426 (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

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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.

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 state-

ments 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.

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

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).

The credit counseling compliance project was a huge undertaking.

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 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 whistleblower 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.

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

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,w 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. ■

[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.