CHAPTER ONE

IRS Audits of Tax-Exempt Organizations: Fundamentals

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

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

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

§ 1.1 INTRODUCTION TO IRS EXEMPT ORGANIZATIONS' AUDIT PROCEDURES

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

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

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

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

[4]See § 1.12.

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

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

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

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

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

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

[8]See § 1.8.

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

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

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

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

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

[14]See § 2.5.

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

[16]See § 2.3.

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

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

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

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

§ 1.2 REASONS FOR IRS AUDITS

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

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

[18]See § 1.13.

[19]IRM 4.75. See Chapter 5.

[20]IRM 4.76. See Chapter 7.

[21]See § 3.11.

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

[23]See App. C § I B.

[24]*Id*. § I F.

[25]*Id*. § I BB.

[26]*Id*. § V C.

[27]*Id*. § V A.

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

§ 1.3 IRS AUDIT ISSUES: INTRODUCTION

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

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

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

§ 1.4 IRS AUDIT PROCEDURES IN GENERAL

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

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

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

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

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

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

§ 1.5 TAX-EXEMPT ORGANIZATIONS' RIGHTS

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

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

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

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

§ 1.6 TYPES OF IRS EXAMINATIONS

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

(a) Field Examinations

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

[48]See § 2.12.
[49]Reg. § 601.105(b)(3). In one instance, an IRS agent conducted a field audit of an organization that had been recognized as a tax-exempt educational organization because of its programs to teach air safety; the examination (which led to revocation of the exemption) took place in the organization's airplane hangar (Priv. Ltr. Rul. 200709064 (May 4, 2006)).
[50]IRM 4.75 11.3.
[51]*Id*.

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

(b) Office and Correspondence Examinations

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

(c) Team Examinations

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

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

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

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

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

(d) Compliance Check Projects

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

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

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

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

§ 1.7 IRS AUDIT CONTROVERSY

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

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

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

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

§ 1.8 IRS SUMMONS AUTHORITY

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

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

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

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

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

§ 1.9 TECHNICAL ADVICE

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

[73]IRC § 7604(a).

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

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

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

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

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

(a) General Procedures in Exempt Organizations Context

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

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

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

[78]Rev. Proc. 2007-2, 2007-1 I.R.B. 88 § 3.01.
[79]The term *taxpayer* means any person subject to any provision of the Internal Revenue Code (Rev. Proc. 2007-2, 2007-1 I.R.B. 88 § 2.05), including a tax-exempt organization (Rev. Proc. 2007-5, 2007-1 I.R.B. 161 § 3).
[80]Rev. Proc. 2007-2, 2007-1 I.R.B. 88 § 3.03.
[81]See § 2.5.
[82]These procedures also are applicable with respect to TAMs issued in the employee plans setting.
[83]Rev. Proc. 2007-5, 2007-1 I.R.B. 161 § 4.01.
[84]*Id*. § 1.01.
[85]*Id*. § 1.02.
[86]*Id*. §§ 3, 4.03.

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

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

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

(b) Pre-Submission Conferences

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

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

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

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

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

(c) Contents of TAM Requests

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

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

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

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

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

(d) Handling of TAM Requests

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

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

(e) Appeals of Decisions to Not Seek Advice

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

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

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

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

(f) Withdrawal of TAM Requests

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

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

(g) Conference Scheduling

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

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

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

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

(h) IRS Use of TAMs

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

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

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

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

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

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

(i) Effect of TAM

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

(j) Limited Retroactive Effect of TAM

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

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

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

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

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

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

(k) Future Use of TAMs

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

§ 1.10 CLOSING AGREEMENTS

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

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

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

(a) Overall Purpose of Closing Agreements

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

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

(b) Authority and Function

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

[134]See § 1.9.

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

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

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

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

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

(c) Scope

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

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

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

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

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

[139]Closing Agreements.

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

[141]Reg. § 301.7121-1(b)(1).

[142]Reg. § 301.7121-1(b)(2).

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

[144]Closing Agreements.

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

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

(d) Finality

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

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

(e) Closing Agreements in Exempt Organizations Context

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

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

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

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

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

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

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

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

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

[152]See *Tax-Exempt Healthcare Organizations* § 35.2.
[153]That is, an organization described in IRC § 501(c)(7). See App. C § I N.

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

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

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

§ 1.11 FREEDOM OF INFORMATION ACT

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

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

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

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

[157]See App. C §§ II D, E.

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

[159]5 U.S.C. § 552(a).

[160]5 U.S.C. § 552(b)(3).

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

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

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

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

§ 1.12 RETROACTIVE REVOCATION OF TAX-EXEMPT STATUS

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

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

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

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

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

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

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

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

[170]Reg. § 601.201(n)(6)(i).

[171]Reg. § 601.201(n)(6)(vii).

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

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

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

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

[172]See App. C, II D.
[173]*Stevens Bros. Found., Inc. v. Comm'r*, 324 F.2d 633 (8th Cir. 1963), *cert. den.*, 376 U.S. 969 (1964).
[174]See *Tax-Exempt Organizations* § 19.12
[175]*West Central Coop. v. United States*, 758 F.2d 1269 (8th Cir. 1985).
[176]See App. C, ID.
[177]See *Tax-Exempt Organizations* § 6.2(b)(ii).
[178]*Prince Edward School Found. v. United States*, 478 F. Supp. 107 (D.D.C. 1979), *aff'd without pub. op.* (D.C. Cir. 1980), *cert. den.*, 450 U.S. 944 (1981).
[179]*Virginia Educ. Fund. v. Comm'r*, 85 T.C. 743 (1985), *aff'd*, 799 F.2d 903 (4th Cir. 1986). Thereafter, an estate tax charitable contribution deduction was denied for a gift to this organization (*Estate of Clopton. v. Comm'r*, 93 T.C.275 (1989)).
[180]*Automobile Club of Mich. v. Comm'r*, 353 U.S. 180 (1957). Also *Dixon v. United States*, 381 U.S. 68 (1965).
[181]*Incorporated Trustees of Gospel Worker Soc'y v. United States*, 510 F. Supp. 374 (D.D.C. 1981), *aff'd*, 672 F.2d 894 (D.C. Cir. 1981), *cert. den.*, 456 U.S. 944 (1982).

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

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

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

[182]See *Tax-Exempt Organizations* § 4.10.
[183]*Presbyterian & Reformed Publishing Co. v. Comm'r*, 79 T.C. 1070 (1982). An appellate court concluded that this organization was engaged in exempt activities, however, thereby voiding this revocation of exempt status (743 F.2d 148 (3rd Cir. 1984)).
[184]*Freedom Church of Revelation v. United States*, 588 F. Supp.693 (D.D.C. 1984).
[185]*United Cancer Council, Inc. v. Comm'r*, 109 T.C. 326 (1997), *rev'd and rem'd*, 165 F.3d 1173 (7th Cir. 1999).
[186]*Birmingham Business College, Inc. v. Comm'r*, 276 F.2d 476 (5th Cir. 1960), *aff'g, mod., and rem'g* 17 T.C.M. 816 (1958) (revocation due to material misrepresentations in the organization's application for recognition of exemption).
[187]*Cleveland Chiropractic College v. Comm'r*, 312 F.2d 203 (8th Cir. 1963), *aff'g* 21 T.C.M. 1 (1962) (consistent private inurement throughout the period).
[188]*The Lesavoy Found. v. Comm'r*, 230 F.2d 589, 594 (3rd Cir. 1956), *rev'g* 25 T.C. 924 (1956).
[189]*Id.*, 238 F.2d at 594.
[190]*Id.* at 591.
[191]*Id.*
[192]*Id.* at 594.

§ 1.13 EXPANSION OF IRS EXEMPT ORGANIZATIONS AUDIT ACTIVITY

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

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

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

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

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

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

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

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

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

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

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[196]See § 2.3(a).

[197]See § 1.6(b).

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

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

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

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

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

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

§ 1.14 CURRENT AND FUTURE FOCUS OF IRS EXEMPT ORGANIZATIONS AUDITS

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

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

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

[203]See § 4.2.

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

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

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

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

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

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

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

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

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

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

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

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

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

The Brown Letter concluded by exploring these four questions:

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

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

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

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

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

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