BY STEVEN TOSCHER AND CHAD NARDIELLO

IRS Scrutiny of Tax-Exempt Organizations

INTERNAL REVENUE SERVICE COMMISSIONER Mark Everson recently urged charities to head off what he called "the gathering storm" of tax compliance problems facing the tax-exempt sector.[1] In its strategic plan for 2005-09, the IRS has identified several problems as abuses by tax-exempt entities and by nonexempt parties that use these entities to avoid taxes or engage in noncharitable activities.

Tax-exempt entities are usually viewed as benign organizations that present the IRS with few issues. However, with enforcement now being given greater attention, the agency is focusing on four abuses involving these entities: 1) abusive tax avoidance transactions, 2) excessive compensation, 3) credit counseling agencies, and 4) diversion of funds to support terrorist activities.

An organization may qualify for tax-exempt status if it serves a public purpose designated by the Internal Revenue Code as justifying exclusion from paying federal income taxes. These include groups benefiting the poor; promoting religion, education, and social welfare; and supporting fraternal organizations.[2] The opportunity to avoid paying taxes has encouraged some to use tax-exempt entities for their private inurement. Self-dealing between insiders and these entities, such as when a director or officer inflates the value of the goods or services sold to a tax-exempt entity, is but one example. In 1996 the intermediate sanction regime was enacted to severely penalize those engaging in such transactions. Self-dealers must now repay the excess benefit with interest to the tax-exempt entity and are liable for a 25 percent tax.[3] Any director who approves an inflated contract is also required to pay a 10 percent tax on the value of the transaction.[4]

A perceived increase in abuses has focused the attention of the IRS on exempt entities. Recent public events—such as the September 11 terrorist attack, the collapse of huge corporations because of executive mismanagement, questionable practices by credit counseling organizations, and a multibillion dollar revenue loss partially caused by tax shelters—have also contributed to the heightened scrutiny.

These events and congressional mandates have given the IRS the impetus to increase its enforcement resources. Under the IRS Restructuring and Reform Act of 1998, Congress directed the agency to organize itself into separate divisions based on taxpayer groupings.[5] Accordingly, the IRS created the Exempt Organizations Division within the new Tax Exempt and Government Entities Division to monitor, apply, and enforce the tax laws applicable to tax-exempt groups. The release in 2004 of the 2005-09 strategic plan established the IRS's new mantra: "Service plus enforcement equals compliance," and the establishment of the Fraud and Financial Transactions Unit (FFTU) in the Exempt Organizations Division augmented the agency's ability to provide law enforcement agencies with expertise on exempt organizations and to track foreign grant activities.

The Exempt Organizations Division's attention to what the IRS characterizes as abusive tax avoidance transactions (ATATs), excessive executive compensation, credit counseling agencies, and terrorist activities is reflected in a recent reallocation of agency staff resources. In fiscal year 2005 the division is dedicating more than 30 percent of its resources to combating these abuses, compared to roughly 5 percent for the previous fiscal year.[6] The hiring by the Exempt Organizations Division of 72 new revenue agents in September 2004 is another example.[7] The IRS also plans to hire an additional 75 new agents by September 30, 2005, to work in the FFTU and the Data Analysis Unit of the Exempt Organizations Division.[8]

ATATs rank as one of the highest IRS enforcement priorities. One group of ATATs identified by the IRS is known as "listed transactions." A listed transaction is defined as a tax-avoidance transaction the IRS has identified by notice, regulation, or other published guidance, or a transaction that is expected to obtain the same or substantially similar tax consequences.[9] Of the roughly 30 different listed transactions identified by the IRS, more than a few involve a tax-exempt entity. Taxpayers participating in listed transactions are contesting the IRS characterization of the transactions as abusive, and these taxpayers continue to affirm the merits of these transactions.

Under recently enacted provisions to the IRC that require disclosure of involvement in listed transactions,[10] a tax-exempt party in a listed transaction can be deemed a participant in the transaction even though it receives no tax benefit.[11] While a tax-exempt entity may assert it is not receiving a tax benefit and is not a participant, the IRS can and will treat a tax-exempt entity as a participant for purposes of satisfying disclosure requirements. Thus, tax-exempt entities need to recognize the arrangements that may qualify as "listed transactions" and the applicable disclosure requirements. Stiff sanctions are imposed on tax-exempt organizations that fail to disclose involvement in a reportable or listed transaction. If a tax-exempt entity fails to make the proper disclosures on IRS Form 8886, it faces a $200,000 penalty that the IRS commissioner cannot rescind and that cannot be appealed.[12]

The risk is also heightened by the authority granted the IRS to determine the types or classes of persons that will be treated as participants in a listed transaction.[13] A tax-exempt entity may become involved in a transaction that becomes listed after the fact. In that case, an entity has the duty to report its involvement in the transaction. Retroactive application of disclosure requirements and penalties for transactions executed in earlier tax years require tax-exempt entities and their advisers to give careful thought to participating in a transaction that could qualify as abusive.

Excessive Compensation

Excessive compensation paid to executives is a second enforcement priority. IRS Commissioner Everson said, "We are concerned that some charities and private foundations are abusing the tax-exempt status by paying exorbitant compensation to their officers and others."[14] Organizations may cross the line by not disclosing the compensation

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they provide or by paying salaries deemed inappropriate because they exceed the fair market value of the services performed. IRS Form 990 (the annual information return required to be filed by most tax-exempt entities) mandates disclosure of all forms of compensation provided to the five highest-paid employees of a tax-exempt entity.[15] Nevertheless, many entities try to evade this requirement by answering "available on request" or using a similar phrase.[16] IRS Form 990 also inquires into whether a tax-exempt entity engaged in any excess benefit transactions during the year or became aware of such a transaction from a prior year. Many tax-exempt entities also fail to answer this question.[17] The IRS is requiring these organizations to provide a response.[18] Failure to answer this question will likely result in a full examination of the tax-exempt entity.

The IRS deems compensation to be excessive when an officer's salary exceeds the fair market value of the services performed by that individual.[19] Many factors are used to determine whether compensation is excessive, including, most importantly, surveys of what executives at other tax-exempt entities are paid. When this threshold is surpassed, the IRS may impose a 25 percent tax on an officer receiving inappropriate compensation and a 10 percent tax against any involved organization manager.[20] An officer would also be required to repay the amount found excessive.[21] If the excessive benefit is not "corrected" within a certain period, the IRS may assess a 200 percent penalty on certain individuals.[22] "Corrected" means the excess benefit is returned to the tax-exempt entity and its financial standing restored as if this benefit had not been conferred.[23]

Compensation may take forms other than cash, such as providing executives with vehicles and other excessive benefits. Many who receive vehicles fail to maintain contemporaneous records of personal mileage. By not tracking mileage, the entire fair market value of the automobile is treated as a benefit and raises the possibility of violating IRS compensation standards.

The IRS introduced the Tax Exempt Compensation Enforcement Project last year to 1) address executive compensation or questionable practices, 2) make entities aware of the tax consequences in setting future compensation, and 3) expand the information available to tax-exempt entities on organizational compensation and reporting practices.[24] In November 2004, Martha Sullivan, Director of the IRS Exempt Organizations Division, said the agency was issuing 2,000 letters to charities asking how they determine executive compensation. She also indicated roughly 25 percent of these charities would be audited on the issue of executive compensation.[25]

A third focus of the IRS's scrutiny of tax-exempt entities are credit counseling agencies (CCAs). Commissioner Everson said, "It is not fair to taxpayers struggling with financial problems to be taken advantage of by credit counseling groups exploiting gaps in the law."[26] CCAs create repayment plans for debtors for a fee. CCAs also provide educational and other financial counseling. According to the IRS, certain CCAs charge "excessive fees to low-income customers for debt management services instead of providing education on how to manage personal finances."[27] This puts the debtor further into debt.[28] Some CCAs partner with a for-profit lending institution to make loans with unconscionable fees and costs.[29] Another abuse requires debtors to make "voluntary contributions" to the CCA.[30]

The IRS is taking a tough stance by working with other federal agencies and state regulators to combat abuse in this area.[31] A compliance team to combat abuses by CCAs has been created within the Exempt Organization function of the Tax Exempt and Government Entities Division.[32]

Congress has previously regulated CCAs by enacting The Credit Repair Organizations Act (CROA)[33] to "protect the public from unfair or deceptive advertising and business practices by credit repair organizations."[34] The CROA imposes restrictions on CCAs and the services they provide. It prohibits CCAs from receiving any payments prior to services being fully performed for a debtor.[35] CCAs may try to circumvent this by using a provision in the CROA excluding any credit repair organization which is a "nonprofit organization…exempt from taxation under section 501(c)(3) of the Internal Revenue Code of 1986."[36] A CCA that satisfies the IRS that it is formed for educational and/or charitable purposes is potentially able to avoid federal consumer protection laws and engage in practices that it would otherwise be prohibited from doing as a nonexempt entity.[37]

Recognizing this, the IRS has denied requests by CCAs for tax-exempt status because the agency concluded the CCAs were formed to circumvent consumer protection laws and not to engage in a legitimate exempt purpose.[38] In rejecting one application, the IRS stated, "An organization cannot prove that it is entitled to exemption where one of its purposes is the avoidance of regulation."[39] The IRS can also examine organizational activities to prevent abuses by CCAs. In addition, the Joint Committee on Taxation recently recommended that Congress impose tougher conditions on CCAs seeking exempt status. The underlying theme of these proposed restrictions is to ensure the purpose of tax-exempt CCAs is to provide consumer education.

Preventing terrorism is another priority. The IRS plays a crucial role in identifying and dismantling organizations supporting terrorism in the United States and elsewhere. Many terrorist organizations use tax-exempt entities—such as religious and other charitable groups—to direct funds from the United States to terrorists abroad. While charitable organizations are restricted from diverting

New IRS Form 1023

To ensure greater understanding of the purposes and activities of an applicant for tax-exempt status and to restrain potential abuses, the IRS recently revised Form 1023: Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code. Any applicant seeking tax-exempt status after April 30, 2005, must use the revised Form 1023. The revised form contains more extensive and detailed questions designed to aid the IRS in making its determination of an entity's eligibility for tax-exempt status. In addition, the IRS is in the process of revising the annually filed Form 990 Return of Organization Exempt from Income Tax to better monitor the activities of exempt organizations.

Most notably, the revised Form 1023 contains a new Part V: Compensation and Other Financial Arrangements with Your Officers, Directors, Trustees, Employees, and Independent Contractors, which is now two and one-half pages in length. This section is designed to more thoroughly disclose the compensation arrangements and other benefits given to officers, directors, trustees, employees, and independent contractors. The revised section includes questions regarding related entities and entities under common control; possible agreements between the entity and its officers, directors, trustees, employees, and independent contractors for compensation bonuses, sales of goods, services, or assets to the entity, and loans with the entity; and whether the entity has adopted a conflict of interest policy consistent with the sample policy provided by the IRS in Appendix A to the form. The new Form 1023 also contains a new Part VIII: Your Specific Activities, including questions regarding the foreign grant-making activity of a potential tax-exempt entity.

The detailed questions in the new Form 1023 reflect the IRS's concerns about excessive compensation, foreign grants, terrorist activities, and other abusive arrangements and will aid the IRS in its efforts to curb such abuses.**—S.T. & C.N.**

funds for noncharitable uses, the IRS is concerned that existing rules are not well-suited to prevent funds from being used to support terrorist activities.[40] The Fraud and Financial Transactions Unit was created to prevent this occurrence.[41] The FFTU is staffed with fraud specialists, forensic accountants, and agents with expertise in tracking foreign grant activities. The unit assists or leads examinations of tax-exempt entities making grants to foreign organizations or individuals with a view toward thwarting terrorist funding. The IRS is also considering revising Forms 990 and 990PF to improve disclosure of foreign grants.[42]

In November 2002, the Treasury Department issued its Antiterrorist Financing Guidelines: Voluntary Best Practices for U.S.–Based Charities. Industry groups opposed the guidelines due to concerns about the administrative costs needed to implement the guidelines, conflicts with state and federal law, and internal inconsistencies within the guidelines. While the Treasury Department agreed to redraft the guidelines, revised guidelines have yet to be published. Although the existing guidelines are voluntary, failure to comply could have potentially adverse consequences under Executive Order 13224, which allows the government to issue an order blocking funds and/or property interests. The IRS has not issued any published guidance regarding these guidelines.[43] Thus, the application of the guidelines remains unclear.

Congressional response to abuses involving financial support for terrorism has also been strong. IRC Section 501(p), enacted in 2003 under the Military Family Tax Relief Act, permits an organization's exempt status to be suspended if it is properly characterized under 1) certain provisions of the Immigration and Nationality Act as a foreign or domestic terrorist organization, 2) an executive order related to terrorism and issued under the authority of the International Emergency Economic Powers Act or Section 5 of the United Nations Participation Act of 1945 for the purpose of imposing economic or other sanction on such organization, or 3) an executive order, referring to IRC Section 501(p)(2), issued under the authority of federal law, if the order specifically identifies the organization as supporting or engaging in terrorist activity or supporting terrorism.[44] No administrative or judicial challenge is permitted when an organization's exempt status is suspended or a charitable deduction is disallowed under IRC Section 501(p).[45]

The USA Patriot Act forbids tax-exempt entities from providing material resources or financial support to foreign terrorist organizations or listed persons.[46] Further, President Bush issued Executive Order 13224 on September 25, 2001, effectively freezing assets located in the United States of all foreign persons engaging in or posing a risk of committing terrorist acts. The order also prohibits making contributions to or dealing in property owned by persons subject to the order.[47]

Legislative Scrutiny

Congress continues to monitor the activities of exempt organizations and consider further changes. On January 27, 2005, the Joint Committee on Taxation issued a staff report proposing new compliance requirements for tax-exempt entities.[48] One major reform would require exempt entities to file a statement with the IRS every five years explaining why the entity still deserves exempt status.

Congress has also sought out the recommendations of tax-exempt entities on the subject. On September 22, 2004, U.S. Senators Charles Grassley and Max Baucus sent a letter to Independent Sector, an organization that represents thousands of tax-exempt entities on national, state, and local issues, requesting it convene a "panel on the nonprofit sector to consider and recommend actions that will strengthen good governance, ethical conduct and effective practice of public charities and private foundations."[49] The Panel on the Nonprofit Sector, convened by Independent Sector, issued its report to Congress in June 2005.[50] The report contains many recommendations, such as requiring financial statements prepared in accordance with generally accepted accounting principles, disclosure of performance data, strengthening of laws and regulations governing donor-advised funds, as well as other recommendations related to travel expenses and noncash contributions.

The report also includes recommendations concerning IRS enforcement. First, the panel suggested increased funding to the IRS for overall tax enforcement and oversight of charitable organizations, as well as an elimination of the statutory barriers that prevent the IRS from sharing information with state officials. Second, the panel made recommendations on the IRS forms filed by charitable organizations. The report includes recommendations for improving the accuracy and completeness of Forms 990, 990-EZ, and 990-PF and the suspension of the tax-exempt status for those entities that fail to correct incomplete or inaccurate returns for two consecutive years. In addition, the panel recommended that Congress impose penalties for those preparers who willfully omit or misrepresent information on the returns. Third, the panel argued that a periodic review to verify that entities are continuing to meet the qualifications for tax-exempt status—as suggested by the Joint Committee on Taxation—would be a misallocation of IRS resources. Rather the IRS should focus on review and investigation of the current returns filed by these entities. Fourth, the report includes a recommendation that Congress make clear to all tax-exempt organizations their responsibilities with respect to reporting involvement in potentially abusive listed and other reportable tax shelter transactions. The panel suggested organization managers should be penalized for failure to properly report an entity's involvement in such transactions, and the tax-exempt entity itself should be penalized for participation in such transactions. Finally, the panel recommended that charitable organizations should be required to more clearly disclose compensation paid to the chief executive officer (and other "disqualified persons") and the five highest compensated employees and recommended increased penalties for those individuals who receive, and managers who approve, excessive compensation.

The perception of tax-exempt entities as benign organizations has been altered by the proliferation of abuses associated with these entities. Abuses run the gamut from individuals using exempt entities for personal gain to organizations engaging in activities raising national security concerns. These abuses and recent current events have provided Congress and the IRS with justification for heightened scrutiny of exempt entities. At the legislative level, more stringent laws have been enacted enabling the IRS to pursue enforcement actions more aggressively against certain tax-exempt entities. Administratively, the IRS has redeployed and enhanced administrative resources, increased audits, assessed greater penalties, and, in some cases, revoked tax-exempt status. The recent increased level of enforcement and scrutiny against tax-exempt entities is unprecedented.

Exempt entities also face other practical consequences from the potential tarnish of their public reputations. Foremost is a reduction in, or the loss of, grants and other public and private funding. Many exempt entities rely on these donations for their existence. Other consequences include broadening the liability of directors and officers of these entities and reducing free public services such as access to public service announcements on various media.

Exempt entities can restore public confidence in themselves and avoid more drastic legislative and administrative action by ensuring that they are fulfilling the public purposes for which they qualified for exempt status. The IRS commissioner has urged the tax-exempt sector to avoid the "risk management and value creation" model that hurt the legal and accounting professions.[51] Tax-exempt organizations that are not adhering

to legal requirements should take the initiative to make any changes needed to demonstrate compliance with these requirements. The IRS as an institution respects self-correction, and an organization's interests are better served by addressing problems before the agency comes knocking at the door. Those entities that persist in abusing their exempt status will need to put on their rough weather clothing and be prepared to encounter an unprecedented level of IRS scrutiny and enforcement action. ■

[1] Allison Bennett, *Everson Cautions Exempts Must Work to Fix Problems or Face "Gathering Storm,"* Daily Tax Rep. (BNA) (Apr. 29, 2005).
[2] I.R.C. §501(c).
[3] I.R.C. §4958(a)(1); Treas. Reg. §§53.4958-1 and 53.4958-7.
[4] I.R.C. §4958(a)(2).
[5] IRS Restructuring and Reform Act of 1998, §1001(a)(3) (P.L. 105-206).
[6] Kurt Ritterpusch, *EO Division Furthering Enforcement Focus, Directing Resources to High-Risk Areas*, Daily Tax Rep. (BNA) (Nov. 9, 2004).
[7] *Id.*
[8] Stephen Joyce, *IRS Working to Combat Abusive Practices by Creating Tax-Exempt Monitoring Priorities*, Daily Tax Rep. (BNA) (Jan. 27, 2005).
[9] Treas. Reg. §1.6011-4(b)(2).
[10] I.R.C. §6707A.
[11] Treas. Reg. §1.6011-4(c)(3)(i)(A).
[12] I.R.C. §§6707A(b), (d).
[13] Treas. Reg. §1.6011-4(c)(3)(i)(A).
[14] I.R.S. News Release IR 2004-106, 2004 IRB LEXIS 350.
[15] Treas. Reg. §1.6033-2(h).
[16] Margaret Graham Tebo, *Greater Scrutiny for Nonprofits*, A.B.A. J., June 2004, at 55 (quoting Betsy Adler, chair of Exempt Organizations Committee, A.B.A. Taxation Section).
[17] Tom Gilroy, *IRS Contacting EOs That Fail to Answer Excess Benefit Questions from Form 990*, Daily Tax Rep. (BNA) (Nov. 23, 2004).
[18] *Id.*
[19] A discussion of exactly what constitutes excessive compensation is beyond the scope of this article.
[20] I.R.C. §4958(a).
[21] Treas. Reg. §§53.4958-1 and 53.4958-7.
[22] I.R.C. §4958(b).
[23] I.R.C. §4958(f)(6).
[24] I.R.S. News Release IR 2004-106, 2004 IRB LEXIS 350.
[25] Tom Gilroy, *IRS Sending Out 2,000 Letters Seeking Information on Charities' Compensation*, Daily Tax Rep. (BNA) (Nov. 19, 2004).
[26] I.R.S. News Release IR 2003-120, 2003 IRB LEXIS 417.
[27] Gordon C. Milbourn III (acting deputy inspector general for audit), Memorandum for Commissioner, Tax Exempt and Government Entities Division 15 (Sept. 29, 2004).
[28] I.R.S. News Release IR 2003-120, 2003 IRB LEXIS 417.
[29] I.R.S. News Release IR 2004-34, 2004 IRB LEXIS 116.
[30] I.R.S. News Release IR 2003-120, 2003 IRB LEXIS 417.
[31] *Id.*
[32] Milbourn, *supra* note 27, at 14-15 (Sept. 29, 2004).
[33] 15 U.S.C. §§1679 *et seq.*
[34] 15 U.S.C. §1679(b)(2).
[35] 15 U.S.C. §1679b(b).
[36] 15 U.S.C. §1679a(3)(B)(i).
[37] *But see* Zimmerman v. Cambridge Credit Counseling Corp. et al., 2005 U.S. App. LEXIS 9901 (To be excluded from CROA, a credit repair organization must actually operate as a nonprofit organization *and* be exempt from taxation under I.R.C. §501(c)(3).).
[38] *See, e.g.*, Priv. Ltr. Rul. 200447046, Priv. Ltr. Rul. 200450039, *and* Priv. Ltr. Rul. 200452036.
[39] Priv. Ltr. Rul. 200452036.
[40] Announcement 2003-29, 2003-1 C.B. 928.
[41] Gilroy, *supra* note 25 (citing I.R.S. EO Division Director Martha Sullivan).
[42] *Id.* (citing IRS Specialist Leonard J. Henzke).
[43] *Id.*
[44] I.R.C. §501(p)(2).
[45] I.R.C. §501(p)(5).
[46] 18 U.S.C. §§2339A, 2339B. Listed persons are found on the Designated Nationals list maintained by the Office of Foreign Assets Control, the U.S. Government Terrorist Exclusion List, and United Nations list.
[47] 66 Fed. Reg. 49079.
[48] 2005 TAX NOTES TODAY 18-18, Tax Analysts (Jan. 28, 2005).
[49] *Letter from Sens. Grassley, Baucus to Independent Sector Regarding National Panel to Make Recommendations to Finance Committee on Oversight and Governance of Nonprofits*, Daily Tax Rep. (BNA) (Oct. 14, 2004).
[50] A copy of the report issued by the Panel on the Nonprofit Sector can be found at 2005 TAX NOTES TODAY 122-50.
[51] Bennett, *supra* note 1.

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