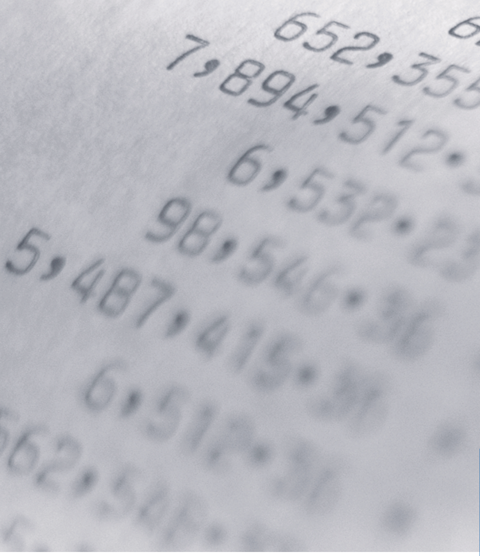

WILMER CUTLER PICKERING HALE AND DORR LLP

EXEMPT ORGANIZATIONS LAW UPDATE

May 26, 2005

Is Your Organization Prepared for a Tax Audit?

IRS Building Resources for Increased Audit Activity

Tax-exempt organizations have been subject to increased scrutiny as a result of recent Congressional investigations and hearings, media reports of alleged abuses, and investigations and enforcement actions by the IRS and other federal and state regulators.

Recently, IRS Commissioner Mark Everson advised the Senate Finance Committee: "We can see that tax abuse is increasingly present in the [exempt organization] sector, and we intend to address it. We will act vigorously, for to do otherwise is to risk the loss of the faith and support that the public has always given to this sector." Commissioner Everson's comments parallel the number one goal of the IRS's Exempt Organization Division (EO), as noted in its 2005 Business Plan: "Building a stronger enforcement presence is EO's top priority in 2005."

Most exempt organizations have not been audited in recent years. However, the number of commissioned audits will soon be increasing. Commissioner Everson has expressed his intent to increase examination efforts in the exempt organization arena. He recently notified Senator Grassley that the IRS's 2004 and 2005 budgets for EO examination have increased by 21%, in comparison to an overall IRS budget increase of 0.5% for 2005. For EO examinations, this translates into a 30% increase in staffing from September 2003 to September 2005.

The following are among the list of subject matters announced by the IRS as top examination priorities and/or issues that our clients have encountered in recent audits:

- Compensation
- Foreign activities
- Insider transactions
- For-profit subsidiaries, joint ventures and other affiliate arrangements (with both nonprofit and for-profit organizations)
- Corporate governance
- Tax-exempt bonds
- Activities not previously disclosed to the IRS
- Section 509(a)(3)-supporting organizations
- Donor advised funds
- Election and lobbying activities
- Low-income housing
- Charitable contributions
- Credit counseling
- Tax shelter intermediaries

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How to Prepare for an Audit

There is no better time to prepare for an IRS audit than before the audit begins. In preparing for an audit, an exempt organization should conduct an in-house review of its operations to make sure that its affairs are in order. An in-house review should, at a minimum, consider the following matters:

- *Review of the Organization's Activities:* An organization should determine whether new activities have been conducted since its original exemption letter. Our experience indicates that exempt organizations often change the scope of operations as originally described in their applications for exemption without obtaining legal advice and/or disclosing such changes in operations to the IRS. This can raise numerous issues, including whether the new activities might, (1) adversely affect the organization's exempt and/or public charity status or (2) result in the imposition of unrelated business income taxes.

- *Review of Policies between the Organization and Affiliated Entities:* Whether an organization has nonprofit and/or for-profit affiliates, the organization should ensure that it has made—in accordance with arm's length transfer pricing principles—proper allocations of income and expenditures. Failure to do so can lead to unrelated business income taxes, various excise taxes and even loss of tax-exemption. An organization should also review issues concerning officer/employee overlap between affiliated entities, incentive and deferred compensation arrangements, and the shared use of assets (intangible as well as tangible) by affiliated entities.

- *Review of Transactions with Insiders:* An organization should review transactions and arrangements with insiders (e.g., sales of assets, contracts for services with companies controlled by insiders, and side-by-side investments) to determine whether the arrangements were adequately disclosed to and authorized by the organization's board of directors and whether such arrangements are still consistent in scope and size with such authorization. Our experience indicates that, very often, a number of transactions and arrangements with insiders are not properly disclosed or authorized, or are conducted in a manner materially different than originally approved.

- *Review of Compensation/Benefits to Officers and Others:* An organization should determine whether it has salary surveys or other information and records to justify executive and director compensation and benefits. An organization should also determine whether it is properly taking into account all of the benefits provided to executives and directors in considering whether compensation is reasonable. Our experience indicates that organizations are often not taking all benefits into account in deciding compensation levels and reporting such levels to the IRS.

- *Review Corporate Governance Procedures:* An organization should review its organizational documents to ensure the documents are up-to-date and in compliance with state law and that the organization's policies do not violate state law (e.g., organizations may have made loans to officers despite state laws prohibiting officer loans). An organization should also consider whether it has adopted a conflicts of interest policy to help guard against potential conflicts of interest with directors, officers and employees, and that members of its board of directors are aware of their fiduciary duties under state law. Organizations often have inadequate corporate governance procedures or do not comply with existing procedures.

- *Review Employee/Contractor Arrangements:* To determine that proper classification, withholding and reporting requirements are being satisfied, an organization should review employee/independent contractor arrangements. Failure to do so can leave the organization exposed to significant employment taxes and other adverse consequences.

- *Review Foreign Activities:* An organization should be reviewed of its foreign activities to ensure that, (1) adequate safeguards are imposed to minimize the risk of violating anti-terrorism and other laws and (2) its operations have taken into account whether foreign income (or similar) taxes or impositions might apply to its foreign activities.

- *Review of Issues Relating to Tax-Exempt Bonds:* An organization should review its use of tax-exempt bond-financed properties. An exempt organization's use of bond-financed property frequently changes after the date the property was financed. Because the tax law imposes strict use requirements, a slight change in use of bond-financed property can jeopardize the tax-exempt status of the bonds.

For information on how to prepare for an audit or on any other exempt organization matters, contact any of the attorneys listed in the table to the right.

EXEMPT ORGANIZATIONS LAW UPDATE

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