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WHAT SHOULD WE EXPECT NOW FROM THE IRS?

by

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I. Introduction

The Exempt Organization (“EO”) Division at the Internal Revenue Service has just gone through its second major reorganization in 15 years. The first major reorganization took place in response to the IRS Restructuring and Reform Act of 1998, legislation adopted by Congress on a bi-partisan basis to modernize the IRS organizational structure. This resulted in an IRS-wide restructuring that included realignment of the IRS into four functional units (Tax-Exempt and Government Entities, Large Business and International, Small Business and Self-Employed, and Wage and Investments) and was generally viewed as a positive development in contributing to effective tax administration.

The second major restructuring took place in 2014 – 2015 under vastly different circumstances. An investigation by the Treasury Department’s Inspector General in 2013 uncovered evidence of IRS mismanagement in the handling of applications for tax exemption for Section 501(c)(4) organizations involved in the political arena. That investigation led to the resignation or termination of a number of senior IRS personnel, including the Acting Commissioner of Internal Revenue, the Acting Commissioner of Tax-Exempt and Government Entities, the Director of Exempt Organizations and a number of other executives in leadership positions in the EO Division. The investigation also led to a number of Congressional hearings and investigations that are continuing to this day, with no end in sight. This controversy has served as the impetus for Congress to make substantial cuts in IRS appropriations, leaving the IRS with significantly fewer resources to handle tax administration and enforcement.

As part of the second reorganization (or “Realignment,” as the IRS calls it), the IRS changed the process for reviewing applications for tax-exemption, introduced a new Form 1023-EZ, largely dismantled the EO headquarters function in the National Office by moving responsibility for the issuance of private letter rulings to the Office of Chief Counsel, and announced changes to the audit process.

While it is too soon to draw firm conclusions on the impact of the Realignment, the outline below offers some initial thoughts and observations.

II. What to Expect in the Processing of Exemption Applications

The Pension Protection Act of 2006 (“PPA”) included a new provision requiring that the tax exemption of organizations be automatically revoked if they failed to file a Form 990 return (including Form 990-N in the case of small organizations) for three consecutive years. The impact of this change was the automatic revocation of hundreds of thousands of tax-exempt organizations. Many of the organizations that were auto-revoked were caught by surprise and reapplied for exemption. The net effect is that exemption applications became seriously backlogged, often taking well over a year.

The IRS recently introduced IRS Form 1023-EZ as a tool to expedite the exemption review process for small organizations. The Form 1023-EZ (attached as Exhibit 1) is very short and functions in essence as a self-certification. Organizations are not required to provide copies of

their governing documents or descriptions of their proposed activities. Instead, they certify that they meet the applicable statutory requirements and on that basis are granted exemption. Organizations that submit properly completed Form 1023-EZs are likely to get exemption within a very short period – in some cases just a few weeks. Since a substantial number of exemption applications are filed by small organizations, the introduction of the Form 1023-EZ has enabled the IRS to reduce its backlog substantially. The backlog has been resolved and many if not most applications are now processed within a few months.

State charity officials and more than a few EO practitioners have expressed concern that the new form 1023-EZ will allow nonqualified organizations to receive exemption. State charity officials are also concerned about the lack of transparency, given the limited information sought on the Form 1023-EZ. Despite these criticisms, the IRS seems intent on keeping the Form 1023-EZ.

There's another significant change in how exemption applications are processed. In the past, applications were assigned to determination specialists in the field based on the perceived complexity of the application. Some types of applications were assigned to determination specialists based on their expertise with particular types of cases. In addition, applications involving issues of first impression were often sent to the IRS National Office for review by tax law specialists there. Both of these processes have changed. All applications are now worked in the field and assigned to determination specialists based on workload and availability rather than expertise with the issues involved. In addition, applications are no longer referred to the National Office.

III. What to Expect in Rulings and Agreements

The IRS Office of Chief Counsel has historically had responsibility for issuing private letter rulings in most areas of the tax laws, with the notable exception of tax-exempt organizations. Instead, private letter ruling requests submitted by tax-exempt organizations were assigned to the EO Division in the IRS National Office, where tax law specialists handled the cases. In recent years, the IRS National Office was very slow in issuing private letter rulings, with some organizations forced to wait for more than two years to get a ruling. Such significant delays made the private letter ruling process of limited value since most organizations could not wait that long for a ruling. Technical advice requests were also handled by the EO Division and were subject to similar delays.

As part of the recent Realignment, responsibility for issuing private letter rulings and technical advice requests has been moved to the Office of Chief Counsel, and many employees of the EO Division moved to that office. The Office of Chief Counsel has internal rules for processing private letter rulings that require relatively prompt attention and so this change is likely to expedite the private letter ruling process. However, a hefty increase in the user fee for private letter ruling requests -- to \$28,300 -- is likely to curtail significantly the number of requests.

When this change was announced, there was concern as to whether the attorneys at The Office of Chief Counsel would be willing to have presubmission meetings with representatives of taxpayers considering the submission of private letter ruling requests. The IRS has announced

that it will have such presubmission conferences, as was the past practice of the EO National Office.

IV. What to Expect in Audits

The IRS Realignment has also resulted in changes to the IRS audit process. In the past, the IRS conducted most audits as part of “compliance projects” in broad issue areas or industry segments identified as having significant audit potential. The recent college and university audit project that was completed a few years ago is an example of a large-scale compliance project. More recently, the IRS has conducted a compliance project involving organizations that reported charitable diversions on their Forms 990. In the past, the IRS EO Division issued an annual work plan that, among other things, listed the major audit compliance projects for the coming year.

The EO Division has not issued a work plan for a couple of years, and it has recently changed its audit strategy to move away from compliance projects. According to Tammy Ripperda, the Director of the IRS EO Division, the IRS is planning to begin using a data analysis approach to pinpoint problem areas and the issues that have the highest risk of noncompliance. Possible issues that Ms. Ripperda identified include nonexempt activities, protection of charitable assets, unrelated business income, excise tax areas, and international activities that impact continuing tax exemption.

The IRS also appears to be conducting audits on a much more streamlined basis. Rather than conducting audits that can last several years and involve hundreds of information document requests, the IRS is more likely to target the audit to a specific issue. In many cases, audits of very large organizations can be closed within a year or less, and in some cases the revenue agent is on site only for a few days.

V. What to Expect in Precedential Guidance

Unlike other areas, the IRS processes for the issuance of precedential guidance have not changed significantly following the Realignment. Precedential guidance is drafted by lawyers at the Office of Chief Counsel, working with the Treasury Department. Treasury and the IRS issue an annual “Priority Guidance Plan” which lists the projects that they expect to work on during the fiscal year. Every year the IRS and Treasury solicit comments from the public about possible topics to include on the priority guidance plan.

The precedential guidance process is extremely slow. For example, we do not yet have proposed regulations on the donor-advised fund rules added by the PPA in 2006. The delay in issuing precedential guidance is a function of a variety of factors, including the intervention of new legislative priorities with urgent deadlines (such as the Affordable Care Act), the complexity of the issues (as in the case of the Section 501(c)(4) regulation project), and the very limited staff at the Treasury Department to work on, review and sign off on projects. As a result, it is not uncommon for guidance projects to take several years or more to complete.

VI. What to Expect in Educational Resources

As noted, as part of the Realignment, many tax law specialists formerly housed at the EO Division in Washington, D.C. have moved to the Office of Chief Counsel where they will work on private letter ruling requests and technical advice memoranda, as well as guidance projects such as regulations and revenue rulings. About 15 – 20 people remain in the EO Division and will work on various issues, including a new initiative called the “Knowledge Management System” for tax-exempt organizations. This is intended to serve as a means for the IRS to collect, organize and share knowledge within the EO Division. It is also intended to preserve and protect institutional memory at a time when an increasing number of long-time IRS exempt organization specialists have retired or are nearing retirement. The EO Division has identified knowledge management as one of its focus areas. Two of the initial topics selected are private foundations and unrelated business income. While the full scope of the Knowledge Management System is still under development, it may eventually include dissemination of information to taxpayers as well as within the IRS.

The IRS offers other educational resources. Many of these focus on topics of interest to smaller organizations that lack the resources to engage outside advisors. For example, the IRS offers regular webcasts on a wide variety of issues and these are published in the IRS e-newsletter.

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In conclusion, the EO function within the IRS remains in flux as the Realignment moves ahead and IRS personnel adjust to yet another set of changes. The most significant impact to tax-exempt organizations may be as a result of funding cut-backs which is likely to result in less IRS attention to matters of guidance, enforcement, exemption processing and overall customer service.