

IRS ENFORCEMENT INITIATIVE FOCUSES ON NONPROFIT ORGANIZATIONS' TAX-EXEMPT BOND COMPLIANCE PROCEDURES

The Internal Revenue Service (IRS) has announced the second stage of an enforcement initiative directed at nonprofit organizations that have used tax-exempt bond financing. Based on comments of IRS officials, we expect that the IRS will target as many as several hundred nonprofit organizations. The IRS expects to start the second stage of the initiative in the first half of 2007.

The Initiative Targets Post-Issuance Compliance

The two-stage initiative is directed at nonprofit organizations that use tax-exempt bond financing. The first stage consists of approximately 30 tax-exempt bond examinations opened by the IRS late in 2006 and is designed to measure compliance in the area of health care and housing financings. In its Tax-Exempt Bond Program Work Plan for fiscal year 2007, the IRS describes "a renewed focus toward improving post-issuance compliance with the use and payment restrictions" that apply to tax-exempt bonds.

The initiative will be expanded from the limited scope examinations opened in 2006 to include a broader survey of different types of non-

Executive Summary

Action: *IRS announces the second stage of an enforcement initiative examining post-issuance compliance by nonprofit organizations that use tax-exempt bond financing.*

Impact: *Nonprofit organizations should develop written compliance procedures.*

Effective Date: *Immediately.*

profit organization financings. In this second stage the IRS Tax-Exempt Bond Program will coordinate with the IRS Exempt Organizations Compliance Unit. The IRS expects that it will review a much larger sample of nonprofit organization financings during the second stage of the initiative.

The First Stage Is Underway

According to IRS officials, two-thirds of the first stage examinations concern health care bonds. The IRS selected bonds issued in late 1997 and 1998 because (1) final regula-

tions dealing with private use became effective on May 16, 1997 and (2) the IRS wanted to review the use of tax-exempt bond-financed projects that had been placed in service for a significant period of time. The first stage examinations focus mostly on private use compliance, but may also consider other issues, such as compliance with tax-exempt bond investment restrictions. The IRS expects that the first stage examinations will be completed in fiscal year 2007.

The Second Stage Will Start With Correspondence

The second stage will take a different approach, but will also focus on post-issuance compliance with the tax-exempt bond private use requirements. We understand that the IRS will likely send detailed questionnaires seeking information about post-issuance compliance procedures to as many as several hundred nonprofit organizations. The main purpose of the initiative is to encourage nonprofit organizations to develop tax-exempt bond compliance procedures and to test the level of their compliance. The IRS will seek to leverage its resources, and reach a large number of organizations, by using an approach relying

mostly on correspondence questions rather than by opening a more limited number of formal examinations.

We believe it is likely that letters will be sent to many types of nonprofit organizations that use tax-exempt bond financing, with a heavy emphasis on health care organizations.

“Compliance Checks” or Formal Examinations?

At this time, it is not clear whether the IRS correspondence questionnaires will be treated by the IRS as “compliance checks” or as formal examinations. In general, the difference is that in a formal examination the IRS would request information about whether a specific bond issue complies with the tax-exempt bond requirements, while in a compliance check the IRS would focus on whether an organization has adopted compliance procedures. In a formal examination, the IRS must follow certain procedures designed to protect the rights of taxpayers. Because formal examinations may be more time-consuming for the IRS, the IRS may prefer to use compliance checks. This compliance approach may be similar to recent IRS enforcement initiatives directed at nonprofit organizations concerning the community benefit standard and executive compensation.

What Questions Will the IRS Ask?

We understand that the IRS has not yet developed the final form of the compliance questionnaire. Based on our discussions with IRS officials, however, we expect that the IRS letters will ask questions such as (1) whether the nonprofit organization has adopted procedures for

post-issuance compliance with the tax-exempt bond requirements and (2) whether the nonprofit organization has identified particular officials within the organization that are responsible for post-issuance compliance. We believe that it is also likely that the IRS will ask for a copy of the tax-exempt bond compliance procedures adopted by the nonprofit organization, if any.

How Will Organizations Be Selected?

It is likely that the IRS will send questionnaires to nonprofit organizations selected from Form 990 information returns for exempt organizations, rather than Form 8038 tax-exempt bond information returns. This approach would be consistent with the “compliance check” approach. Thus, unlike the first stage of the IRS’s enforcement initiative (and many prior IRS initiatives), this stage of the initiative may not be targeted at bonds issued during any particular period of time.

How Should An Organization Respond?

We believe that if an organization fails to adequately respond to an IRS correspondence questionnaire, then it is highly likely that the tax-exempt bonds of the organization will be selected for formal examination by the IRS. The IRS Tax Exempt Bond Program has in the past taken such an approach in following up on its correspondence examinations, such as it did with correspondence examinations that targeted arbitrage rebate compliance.

We also believe that an organization that has adopted post-issuance compliance procedures will be treated more favorably. An organi-

zation that advises the IRS it has such procedures will be less likely to have its tax-exempt bonds selected for follow-up formal examination than an organization that advises the IRS the opposite.

Particularly in light of the possibility of a follow-up examination, we recommend that an organization that receives a questionnaire should retain attorneys who are expert in tax-exempt bond compliance matters to help to prepare the response.

What Should An Organization Do To Get Ready?

We recommend that nonprofit organization borrowers that have used tax-exempt financing, and have not already implemented a formal tax-exempt bond post-issuance compliance procedure, should do so at the earliest possible time. Also, because the IRS may select organizations for review based on information contained in Form 990 information returns, it is advisable to review the tax-exempt bond information set forth in those returns filed by the organization for prior years.

If you have questions or concerns about this new IRS initiative, please contact **Michael Bailey** (m Bailey@foley.com) in our Chicago office, **Chauncey Lever** (c Lever@foley.com) in our Jacksonville office, **Elizabeth Blutstein** (e Blutstein@foley.com) or **Dana Lach** (d Lach@foley.com) in our Milwaukee office, **Mark Schieble** (m Schieble@foley.com) in our San Francisco office, **Dick Riley** (r Riley@foley.com) in our Washington, DC office, or the member of the firm who normally handles your legal matters.

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