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Tax Notes

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EO AUDITS FOCUSING ON INUREMENT, 403(B) PLANS, BOND FINANCING.

Exempt organizations can expect the Service to continue its focus on the Coordinated Examination Program (CEP) in fiscal 1995, according to Marc Owens, director of the IRS's Exempt Organizations Technical Division.

Speaking September 12 in Washington at an EO tax forum sponsored by Faulkner & Gray, Owens noted that most of the 79 CEP audits currently underway involve health care organizations, and that the Service expects to close a number of these audits this year. Owens said one audit already has been closed adversely, and while he would not discuss specifics, it has been learned from other sources that an unidentified health care provider saw its exemption revoked based on inurement resulting from the purchase and sale of physician practices and from excessive compensation.

Owens said the revocation indicates that the CEP audits are raising significant issues not previously detected by the IRS. He cited as examples inurement and/or private benefit arising from extraordinary compensation arrangements, as well as unrelated business tax generated from sales activities.

The Service also has uncovered problems with section 403(b) plans, Owens reported. "We have yet to come across a [403(b)] plan that has met all the requirements that the IRS has set out," he said. If a section 403(b) plan is handled incorrectly, the Service could "mechanically" apply all the participating employees' contributions to taxable income, he warned.

Another big component of the CEP audits is exempt-bond financing. According to Owens, his division has begun to develop and implement an ongoing examination program in this area as well as an increase in informal and formal guidance for revenue agents and the general public.

Overall, Owens said, the Service is pleased with the new team approach afforded by the CEP audits. "We're seeing better-developed cases using the team approach."

Other Fiscal 1995 Priorities

Owens also outlined other aspects of the EO division's work plan for fiscal 1995. One priority is a more systematic approach to case selection and workload management. To accomplish this, the Service will use statistical sampling techniques to establish "profiles"

of discrete market segments in the EO area, he said. The IRS will create a library in the National Office from which field agents will be able to obtain information about particular market segments. Owens said that initially [P. 1517] the Service will focus on section 501 (c)(4) organizations -- "a small, relatively well-defined group."

Another pending issue is contributions by section 501(c)(3) organizations to political candidates. Charitable organizations are prohibited from making such contributions, and if an organization contributes to a campaign, the Service will impose an excise tax on the expenditure.

"This is not an intermediate sanction," he said. "This is considered to be a taxable event." In addition, the organization remains in danger of having its exemption revoked. He added that since this is an election year, "we are looking out for [prohibited political activity]."

The Service is also looking at associate member dues. The Service has taken the position in two technical advice memorandums (LTRs 9345004 and 9416002) that under certain circumstances, a membership organization's income from associate or patron member groups should be reclassified as unrelated business taxable income from the provision of services. (See also p. 1518.)

Some groups, the Service has found, are only interested in particular goods or services associated with membership, such as an association credit card. This would trigger UBTI for the organization, Owens said. He added that if an organization has different classes of membership, it should document the reasons for having the different classes. To date, he said, the IRS has focused on trade associations and labor unions, but there is no reason the Service's position could not apply across the board.

Owens noted IRS Announcement 94-117 (for a summary, see p. 1533), which provides that affiliates of governmental units are no longer required to file a Form 990. According to Owens, the Service found that the information affiliates report on the Form 990 is already available from other forms and other publicly available sources. Consequently, the Service believes "there is no need for a 990" from these institutions. "That is not to say," he added, "that the 990-T will not be required -- just the 990 [will be excused]."

Effect of Health Reform

Health care reform will mean increased scrutiny of exempt hospitals and other exempt health care organizations, and likely will result in the expansion of exemption requirements, predicted Bonnie Brier, general counsel for The Children's Hospital of Philadelphia. Brier addressed the conference September 13 along with Francis McDaniel of Brock & Clay, Marietta, Ga.

Brier said health care reform legislation may base tax exemptions on compliance with nontax policy issues such as fraud and abuse, patient dumping, and antitrust considerations. Reform will be accompanied by increasingly sophisticated IRS audits and by less sympathetic responses from courts and the public, Brier predicted.

McDaniel pointed out the trend of hospitals in the same community affiliating with each other to reduce duplicative services. The next step, he said, is merger (or integration) to achieve economies of scale and to share profits and losses. McDaniel noted that when an exempt health care organization purchases a medical practice, it is important that an independent appraisal be made. Also, he said, the practice should be valued on an after-tax basis.

Brier said that, given the health reform climate, the challenge for exempt organizations is to articulate a mission and to have a favorable relationship with the public. The challenge for the Service is to apply charitable concepts in new situations, she concluded.

Inurement Versus Benefit

Appearing September 12 at the conference was Joseph E. Lundy, of Ballard, Spahr, Andrews & Ingersoll, Philadelphia, who characterized private inurement and private benefit issues as "extraordinarily important . . . the highest profile [tax] issue before Congress, Treasury, and the IRS." In cautioning EO groups to beware of this [P. 1518] "slippery issue," Lundy distinguished inurement from benefit by saying, "Private inurement is absolute, whereas private benefit is permitted so long as it is incidental."

Echoing Owens, Lundy said the proscription against political contributions is also a hot issue. There is a bias in Congress against campaign contributions by exempt organizations, he noted. Charitable (c)(3) organizations are becoming bigger, wealthier, and more powerful, and Congress is concerned over how charities might use that power to sway legislation.

To help steer clear of inurement problems, exempt organizations must exercise care in defining key employees, setting compensation arrangements, and documenting expenditures adequately, according to **Robert W. Wood**, an attorney in private practice in San Francisco who spoke September 13.

Wood reiterated that no part of the net earnings of an exempt organization may inure to the benefit of the organization's insiders. Thus, one of the keys to avoiding private inurement is determining who qualifies as an "insider." Wood listed directors, trustees, officers, and key employees as insiders, and warned that family members of insiders also are on the list.

Excessive compensation is one of the primary places where the Service has found private inurement, Wood reported, stating that EO officials should ensure their salaries are not "out of sync" with those at comparable organizations. He noted that dramatic increases in compensation or compensation that is tied to donations will be questioned by the Service. The "bottom line," said Wood, is that anything unusual will be scrutinized.

Wood also pointed out that use of employees for personal matters or outside business can constitute inurement, as can the use of facilities for personal or business purposes. He advised EO officials to appropriately document reasons for travel and entertainment

expenses.

Organizations can look to the private foundation rules regarding self-dealing for guidance in avoiding private inurement, Wood said. Periodic review by an outsider also is a good idea, he advised.

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