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IRS Examinations—The Seven Stages of Grief

Your 501(c)(3) organization received an IRS Form Letter 3611 in the mail. It reads, “Dear Sir or Madam: We plan to conduct an examination for the above periods on the date, time, and location indicated above.” Attached to the form letter is an Information Document Request, or “IDR,” on IRS Form 4564. It lists 10 to 15 types of documents that the IRS wants to review. *In order to make it through the examination, you need to process the seven stages of grief.*

Stage I—Shock and Denial.

“We did not do anything wrong. This must be a mistake.”

Well, actually, many organizations are examined (i.e., audited) either because: (1) they are one of a type of organization that is being audited by the IRS in any given year (past examples have included hospitals, universities, community foundations, and recently, large private foundations); (2) somebody has complained about the organization either through the press or directly to the IRS; or (3) the organization was just randomly selected for audit (often called “audit roulette”). In any case, accept the fact of the exam. It is not a mistake. Your organization will not avoid the exam.

Stage II—Pain and Guilt.

“OK, OK, we are being audited. What could we have done wrong? What could it be?”

Very likely, the organization has not done anything wrong, but if it has, it would be helpful to know about any problems and address them before the IRS examiner arrives. At this point, an exempt organization should contact its CPA and its attorney to talk about how to handle the examination and alleviate the pain. Usually legal counsel will advise dealing with irrational fears by organizing the materials the IRS examiner is requesting, figuring out in advance if there are going to be any issues to resolve with the IRS, and then making an audit game plan.

Stage III—Anger and Bargaining.

“This is a waste of my employees’ time and charitable resources; we are angry.”

The organization may be angry that it has to put so much time into preparing for the IRS audit, and the personnel in charge of putting all the paperwork together that is being requested in the IDR may even feel angry and put upon, but being audited by the IRS is just something that has to be dealt with in the course of business. Counsel will advise methodically going through the IDR and collecting all of the documents. In general,

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Nonprofit Law Matters looks at legal issues in the nonprofit and tax-exempt organizations world. Written by the attorneys and paralegals of Adler & Colvin, it provides updates and analysis regarding philanthropy, charity, and other exempt organization issues.

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except for attorney-client privileged documents, the IRS is entitled to see most documents that are listed in a properly-drafted IDR, including several years' worth of minutes, correspondence, and contracts. Sometimes, if a request seems overwhelmingly burdensome, you can talk with the IRS examiner and narrow down the request. We usually advise that the documents be assembled and sent to legal counsel for review before being presented to the IRS. Many potential problems can be identified and fixed prior to the exam.

Stage IV—Depression.

“The IRS examiner said he would be looking at documents for two weeks; I cannot handle this.”

Don't get depressed. IRS exams happen. Legal counsel and the CPA can help.

Stage V—The Upward Turn.

“Now that we have started, it's not so bad.”

That's right. You need to treat the IRS exam like any other project. If you organize the documents that the IRS has requested, work with legal counsel and the CPA, find a quiet place for the IRS examiner to work (either onsite or offsite), limit the IRS's access to documents that it has requested in writing, and organize any interviews that the IRS requests with staff, it really is not that bad. The IRS tends to be reasonable in most exempt organization audits unless given a reason not to be.

Stage VI—Working Through.

“Hey, we are getting through this, but the IRS has identified some problems.”

Usually, the exam will be fine, quick, and painless. Usually the organization will receive a “no change” letter, meaning that the IRS did not find any problems. Sometimes, the IRS will find a problem. Depending on the scope and type of problem, it may require some changes. If you are prepared, you are not likely to be surprised by IRS concerns and will have already worked out a plan to propose for how to deal with the problems. An outcome that results in losing exempt status or paying any taxes is rare.

Stage VII—Acceptance and Hope.

“Not only did the exam go well, but we learned some things from the IRS and in the preparation for the audit.”

Very often the result!