



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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Dear Colleagues, Members of the Press and Taxpayers,

The tax-exempt community's response to the devastating hurricanes is a recent reminder of the inspiring work charities do everyday both here and abroad and the public's reliance on the services they provide. Protecting the public trust in these organizations and guarding the financial benefit of tax-exempt status necessitates close scrutiny by the IRS. Fortunately, the overwhelming majority of tax-exempt organizations try hard to comply with the letter and spirit of the law, and the tax-exempt community, itself, recognizes the need to protect the reputation of the sector. This was exemplified by the recommendations in the report by the Panel on the Nonprofit Sector; in particular, the recognition of the need for a stronger enforcement presence by the IRS.

Responding to this heightened awareness in Congress and the EO community for a stronger enforcement presence, IRS Exempt Organizations (EO) transitioned to a more balanced approach to our mission in fiscal year (FY) 2005. We continued to maintain the gains made in customer service, education and outreach in previous years while expanding, reorganizing and building upon our enforcement structure. A stronger enforcement presence will enable EO to better target and address abuses in the tax-exempt sector, one of the four Service-wide strategies identified by IRS Commissioner Everson.

The emphasis on enforcement required a cultural shift as much as a shift in resources within EO. To begin the transition to enforcement, we identified four critical enforcement initiatives in our [FY 2005 Implementing Guidelines](#). Each function within EO focused on improved enforcement in these areas as well as our traditional general program matters. Issue management teams (IMT) focused on specific abuses to ensure the law is enforced, to educate the public and to prepare guidance where appropriate. This coordinated approach was very effective in FY 2005 and will serve as our model in FY 2006.

During FY 2006, we will continue this transition by completing the critical initiatives started in FY 2005, analyzing the results to better target noncompliant organizations, and by enhancing our enforcement efforts through new organizational units and processes.

Before describing our work plan for the coming year, I would like to highlight some of our accomplishments during FY 2005.

FY 2005 Accomplishments

Disaster Relief

Based on lessons learned following the terrorist attacks of September 11, 2001, and the tsunami of December 2004, EO acted swiftly after Hurricane Katrina by immediately issuing a press release urging citizens to seek out qualified charities when making donations to help the hurricane victims. We also provided an expedited review and approval process for new organizations seeking tax-exempt status for providing relief to victims of Hurricane Katrina. In order to assist the public, we ensured that Publication 78 was constantly updated on the irs.gov website. In coordination with Counsel and Treasury, we extended the filing deadline for certain exempt organization returns. Working with other parts of the IRS, we alerted the public about a leave-donation program that also would benefit the hurricane victims. In addition, our Financial Investigations Unit (FIU) coordinated with the Criminal Investigation (CI) Division on Katrina related scams.

Curbing Abuses

During FY 2005, EO made significant progress in addressing abuses using issue-oriented compliance teams that included members from Examinations, Rulings and Agreements (R&A), Customer Education and Outreach (CE&O) and Counsel. R&A began focusing much of its efforts towards assisting Examinations on critical initiative cases. Examinations made steady progress in placing critical initiative returns in the examination process and closing a significant number with a high change rate. CE&O placed information about the abuses on irs.gov and assisted each team with a communication plan.

We began using more sophisticated methods for selecting noncompliant cases for examination. Our new Data Analysis Unit (DAU) utilized available databases along with analyses of Form 990 line items to predict noncompliant returns. We revised Form 990 for tax year 2005 to include expanded information on such key issues as executive compensation.

In FY 2005, our Exempt Organizations Compliance Unit (EOCU) contacted over 19,700 organizations concerning various compliance and educational issues. This was a significant increase over the 9,500 organizations contacted in FY 2004. One project involved organizations that did not file Form 990, but had reported gross receipts from gaming in excess of \$25,000 to the state. A significant number of compliance checks were either forwarded for examination, or resulted in the organization filing a delinquent return. We also sent approximately 1,250 compliance check letters regarding excessive compensation to a wide range of charities and private foundations. These letters asked questions about salaries, loans and other issues that impact compensation.

Accomplishments in our four critical initiative areas include:

1. Abusive Tax Avoidance Transactions (ATAT).

- We began shifting our resources to address issues relating to abusive organizations. In particular, the percentage of examinations involving ATAT issues increased as did the time R&A devoted to supporting these examinations.
- We collaborated with the Small Business and Self-Employed (SB/SE) Division and the Large and Mid-Size Business (LMSB) Division to address compliance risks and formulate ATAT strategies in the areas of excessive compensation, credit counseling, supporting organizations, charitable trusts, producer-owned reinsurance companies (PORC) and Housing and Urban Development (HUD) housing programs.
- We brought our Determinations organization into the compliance arena by implementing the “Touch and Go” or TAG program. This program has been successful in identifying potentially abusive organizations during the determination process thus highlighting abuses as early as possible.
- We worked with HUD to identify potentially abusive organizations participating in HUD housing programs. In addition, we worked with Counsel to draft formal guidance for organizations involved in HUD down-payment assistance programs.
- We identified and began examinations of potentially abusive and non-abusive donor-advised funds.
- We identified and began examinations of section 509(a)(3) supporting organizations that were being used by promoters in abusive tax avoidance schemes.

2. Anti-Terrorism

- We began examinations of a sample of foreign grant-making organizations to ensure that grant funds are being used for their intended charitable purpose and not diverted for terrorism or other inappropriate purposes. In addition, this project is gathering information on the existence and effectiveness of the current controls used by these organizations to monitor their foreign grant distributions.
- We provided fraud training to all EO employees.
- We trained CI agents on exempt organization issues, and provided technical assistance to CI in terrorism-related investigations.
- We continued to work closely with Treasury and other agencies, including the Department of Justice, on terrorism task forces and specific cases.

3. Credit Counseling

- We moved aggressively to address abuses in the credit counseling industry with new as well as existing organizations.
- We coordinated cases with LMSB, SB/SE, CI, offices of Attorneys General, and the Federal Trade Commission.
- We conducted in-depth, comprehensive reviews of all credit counseling applications, resulting in numerous organizations failing to obtain exempt

status, because they either failed to meet the legal requirements for tax-exempt status, failed to provide information to establish that they meet the legal requirements, or withdrew their application.

- We revoked and proposed revocation of a number of credit counseling organizations accounting for approximately 35% of the industry's gross receipts.
- To facilitate implementation of the Bankruptcy Act, we worked with the Office of the U.S. Trustee to prepare them for their review of applications by organizations seeking to counsel taxpayers before and at the end of the bankruptcy process.
- We held the first-ever conference of a Federal/State Consumer Credit Counseling Compliance Group which is designed to foster expanded cooperation with state regulators.

4. Excessive Compensation

- We conducted a significant number of examinations involving excessive compensation. As we indicated, the EOCU sent approximately 1,250 compliance check letters to a wide range of 501(c)(3) organizations and private foundations regarding their compensation practices. We analyzed the results of our efforts and will be better able to target more productive cases involving compensation.
- We also held the first Federal/State Compensation Compliance Group conference.

Guidance

In FY 2005, we were involved in issuing guidance on a wide-range of technical issues including:

- Revenue Ruling 2004-112, which provides guidance on the qualified convention and trade show activity exception to the conduct of an unrelated trade or business as it applies to internet activities conducted by a 501(c)(6) trade association,
- Regulations (TD 9163) under section 6081 of the Internal Revenue Code (IRC) regarding automatic extensions of time to file certain information returns and exempt organization returns,
- Regulations (TD 9173) under IRC section 6104 regarding fees the IRS may charge for providing copies of materials that must be publicly available,
- Regulations (TD 9175) requiring certain organizations to file their Forms 990 or 990-PF electronically,
- Regulations (TD 9206) for the filing of information returns by donees relating to qualified intellectual property contributions,
- Regulations (70 F.R. 53599-53604) clarifying the relationship between the substantive requirements for tax exemption under 501(c)(3) and the imposition of IRC section 4958 excise taxes,
- Notice 2005-44, which provides interim guidance on the deductibility of vehicle contributions under IRC section 170(f)(12),

- Notice 2005-41, which provides guidance on qualified intellectual property contributions, and
- Notice 2005-13, which provides transition relief under IRC section 470 to partnerships and other pass-through entities that are treated as holding tax-exempt use property under IRC section 168(h)(6).

Electronic Initiatives

We developed and implemented modernization projects that support our transition to enforcement.

- We partnered with 26 states to develop requirements for exempt organizations to file Forms 990 and state registration forms through a single transmission (Federal/State Single Point Filing). This effort will be implemented in January 2006.
- We expanded Modernized e-File to include Form 990-PF.
- We conducted a survey of preparers and tax-exempt organizations to get feedback about electronic filing.
- We initiated the process of converting determination case files from microfiche to electronically available images.

Customer Education & Outreach

We continued to educate the EO community regarding their tax responsibilities with increased emphasis on alerting the public to specific enforcement issues and initiatives.

- We conducted 18 Small and Mid-Size Exempt Organizations workshops reaching over 2,000 individuals involved in the day-to-day activities of 501(c)(3) tax-exempt organizations.
- We conducted our first “phone forum” during which determination specialists discussed the newly revised Form 1023. We received overwhelmingly positive responses from the 291 participants.
- We made a number of improvements to our Charities and Non-Profits page on irs.gov, including new links to state government sites, information about e-filing Forms 990, 990-EZ and 990-PF, and a new ATAT page.
- We launched “EO Update” a new email subscription database (listserv) to communicate topics of importance to the EO community. In less than a year, the newsletter subscriber base has grown to more than 10,000.
- We participated in the IRS Nationwide Tax Forums reaching over 8,500 individuals at our workshop on completing Form 990 and our seminars on the revised Form 1023 and political and lobbying activities of 501(c)(3) organizations.

Other Priorities

As most of you know, Congress intensified its focus on abuse in the tax-exempt sector. In April, Commissioner Everson testified before the Senate Finance Committee about EO’s enforcement challenges. In May, he testified before the House Ways & Means Committee on hospitals. In addition, our TE/GE Commissioner appeared before the Senate Finance Committee and before the Oversight Subcommittee providing testimony

on easements. EO assisted in the preparation of testimony and briefing materials for these congressional hearings.

The budget provided for increased hiring, and we hired 105 new revenue agents, which significantly improves our enforcement presence. This unexpected increase in staffing required us to shift significant resources to hiring and training.

Given our responsibility to enforce the 501(c)(3) prohibition on political intervention, we began a project to first educate 501(c)(3) organizations about the rules and then to enforce the prohibition. The project resulted in numerous changes in behavior. The team is developing procedures for the next cycle for accelerated processing of political intervention referrals to ensure efficient enforcement of the tax laws in this area.

We completed the program launched in FY 2004 to ensure that section 527 political organizations meet their public reporting responsibilities. Based on the results of this program, we recommended changes to the Form 8872 instructions to clarify reporting requirements.

New Offices and Structure

During FY 2005, EO reorganized and added several new units to enhance our enforcement efforts. Below is a brief description of the new offices. At the end of this document, I have included the new organizational charts for EO Examinations and EO R&A.

- **EO Financial Investigations Unit (FIU):** This unit focuses on financial transactions that are structured to avoid tax as well as potential fraud cases. The unit will develop its own cases and assist other agents with their cases, assist on criminal investigations and provide expert testimony on EO related issues at trial. This unit commenced operations on April 1, 2005.
- **Compliance Strategies and Data Analysis Unit (CSDA):** The **Data Analysis Unit (DAU)** identifies areas of noncompliance using trend research and analysis. **Compliance Strategies** uses the information developed by the DAU to propose strategies for improving compliance through examinations, compliance checks, and educational activities.
- **Exempt Organizations Compliance Area (EOCA):** This area includes three **Exempt Organizations Compliance Unit (EOCU)** groups and the new **Review of Operations (ROO) Unit** established in late FY 2005. The ROO will follow up on certain organizations within the first 3 years of having received tax-exempt status.
- **Area Offices:** In order to utilize our resources more efficiently, we consolidated our examination area offices from six to five. The Examinations organizational chart at the end of this document lists the five area offices.

FY 2006 Priorities

In the coming year, EO will continue its balanced approach to tax administration through its emphasis on enforcement and addressing abusive transactions, while maintaining

education and outreach to the tax-exempt community. The new units mentioned above will be fully functional in FY 2006, thereby increasing our enforcement capabilities. We will continue to pursue abusive tax avoidance through targeted examinations. The critical initiatives commenced in FY 2005 will be completed in FY 2006. We will evaluate the data obtained from those examinations to determine the need for guidance or more focused enforcement projects. By increasing the number of compliance checks, the EOCU will expand the reach of EO's enforcement program with minimal use of resources.

New initiatives planned for FY 2006 involve abuses in the following areas:

- Easements – both façade and conservation
- Charitable trusts
- Charities Facilitating Abusive Transactions – *Accommodation Parties*
- Hospitals – potentially on compensation and community benefit standards

The Form 990 revision project will continue throughout FY 2006. The result of this comprehensive overhaul will be a superior information return that will increase transparency and improve its usefulness as a compliance tool.

We will continue to work with Counsel and Treasury in issuing new guidance on issues that further our strategic goals as well as ones that are of concern to the tax-exempt community. In particular, the FY 2006 Priority Guidance Plan includes:

- Guidance on donee reporting for car donations
- Guidance on down-payment assistance organizations
- Guidance under section 501(c)(15)
- Guidance under section 527(l)
- Regulations under section 529 regarding qualified tuition programs

While enforcement is an important part of the compliance equation, promoting a better understanding of tax law and providing quality service to taxpayers remains critical to EO's mission. We will continue to reach out to small and mid-size tax-exempt organizations by leveraging technology to maximize the reach of our programs, including a redesign of the tax-exempt section of irs.gov and the development of a series of web-based training modules based on the content of our Small and Mid-Size Organizations workshop.

EO will continue to improve business results and efficiency through automation enhancements. Development of the TE/GE Determinations System (TEDS), which will replace the current methods used for processing and tracking applications for tax-exempt status, will undergo further piloting before implementation. We will continue to develop an interactive application for completing Form 1023. This program will use a "Cyber Assistant" to guide the applicant through Form 1023. In addition, we will develop a risk model for case selection in one or more specific categories. Use of this model will allow EO to select more productive or non-compliant examination cases.

The EO team has worked hard over the last year to effect a shift to enforcement, while maintaining a critical balance with customer service and taxpayer education. We have made significant strides and I congratulate each member of our team on the progress we have made. I also want to express my gratitude to the exempt community for its support of our enforcement efforts and for continuing to provide wide ranging input to us as we make critical decisions. Much work remains and the transition to enforcement will continue to be our primary focus in FY 2006. Each of the programs mentioned above, and others, are described in more detail in the pages that follow.

Sincerely,

Martha Sullivan
Director
Exempt Organizations

**FY 2006
EXEMPT ORGANIZATIONS
(EO)
IMPLEMENTING
GUIDELINES**

The mission of Exempt Organizations is to provide Exempt Organizations customers top quality service by helping them understand and comply with applicable tax laws, and to protect the public interest by applying the tax law with integrity and fairness to all.

October 2005

CONTENTS

New Critical Initiatives	page 11
Ongoing Critical Initiatives	page 12
Other Compliance Projects	page 15
EOCU Initiatives	page 16
Guidance	page 17
Market Segment Studies	page 17
Other Projects	page 17
Customer Education and Outreach	page 18
Electronic Initiatives	page 19
EO Organizational Chart	page 21
EO Examinations Organizational Chart	page 22
EO R&A Organizational Chart	page 23

The TE/GE Strategic Plan for FY 2006-2007 provides for improving the IRS presence in the tax-exempt community to promote greater overall compliance and fairness. On April 5, 2005, Commissioner Everson testified before the Senate Finance Committee on EO's enforcement concerns, accomplishments, and future direction. In keeping with the Commissioner's testimony and TE/GE's strategic plan, EO activities and programs in FY 2006 will continue to emphasize enforcement while maintaining its educational and outreach efforts. The examination program will continue its focus on abuses within the EO community, increasing its coverage rate and enhancing its ability to select more productive cases for examination. Rulings and Agreements (R&A) will provide even greater assistance to critical examination programs while continuing to address determinations, private letter rulings, technical advice memorandums, and guidance projects. Customer Education and Outreach (CE&O) will increase the number of stakeholders it reaches by expanding the use of web-based programs. The Electronic Initiatives Office will expand TE/GE's electronic filing capability and support many of EO's other projects.

New Critical Initiatives

- 1. Easements:** In recognition of the need to preserve our heritage, Congress allowed an income tax deduction for owners of property who give up certain rights of ownership to preserve their land or buildings for future generations.

Recognizing the potential for abuse in this area, Congress held hearings on this issue in June. Our TE/GE Commissioner testified before the Senate Finance Committee and before the Oversight Subcommittee on the tax laws relating to contributions for conservation easements and the steps the IRS is taking to enforce these laws.

The IRS has seen abuses in this area that compromise the policy Congress intended to promote. Taxpayers, often encouraged by promoters and armed with questionable appraisals, take inappropriately large deductions for the donation of conservation easements to tax-exempt organizations. Further, the conservation easement rules place the charity in a watchdog role. In a number of cases, however, the charity has not monitored the easements, or has allowed property owners to modify the easement or develop the land in a manner inconsistent with the easement's restrictions.

The second concern arises in connection with façade easements. Here again, some taxpayers are taking improperly large deductions based upon inflated appraisals. With façade easements, the donor agrees not to modify the façade of the building and donates the façade easement to a charity. However, if the façade was already subject to restrictions under local zoning ordinances, the taxpayers may be giving up nothing, or very little.

A cross-functional Issue Management Team (IMT) was formed to address potential abuses in this area. The team will be alert for developing patterns of abuse and identify promoters of potentially abusive easement donations.

We will examine charities that receive conservation or façade easements. These examinations will continue throughout FY 2006, and we will coordinate them with the donor examinations in other IRS divisions. In addition, we will identify other organizations involved in abusive easement arrangements.

- 2. Charitable Trusts:** Some promoters have established purported charitable trusts for a taxpayer's personal benefit. There are a variety of schemes, all without legal merit, designed to allow individuals to deduct amounts that ultimately will be used for their personal expenses. The trust typically is a nonexempt trust formed under state law that serves as a holding entity of the individual's assets. Individuals retrieve these assets at will, generally through loan transactions, gifts, or by having the trust pay for expenses directly.

In 2005, the Small Business and Self-Employed (SB/SE) Division referred 50 exempt organizations that were involved in a promoter scheme to us. EO will continue working with SB/SE on these examinations. EO is continuing to identify additional transactions involving clear abuse.

- 3. Charities Facilitating Abusive Transactions – Accommodation Parties:** The IRS is concerned about the role of tax-exempt organizations in facilitating abusive tax shelters. For example, in Notice 2003-81 (December 2003) the IRS identified and challenged transactions involving the assignment of offsetting foreign currency options to an accommodating charity. The investor makes a contribution of these options to a charity in order to claim a substantial artificial loss in addition to a smaller charitable contribution. In this and other abusive transactions, the IRS is gathering information about the exempt party. In FY 2006, we will contact identified charities to learn more about their involvement and, where appropriate, pursue formal examinations.
- 4. Hospitals:** We are considering an EOCU compliance project to determine how hospitals determine and pay executive compensation as well as how they meet the community benefit standards for purposes of section 501(c)(3). The project would involve EOCU sending compliance check letters to a significant number of hospitals asking them to answer certain questions regarding these and potentially other issues.

Ongoing Critical Initiatives

The four critical enforcement initiatives identified in our FY 2005 Implementing Guidelines continue in our 2006 work plan.

- 1. Abusive Tax Avoidance Transactions (ATAT):** Although the majority of tax-exempt organizations carry out their valuable role in full compliance with the letter and spirit of the law, abusive tax schemes can involve various types of exempt organizations. Whether initiated by organization insiders or by third parties using the cover of charitable purposes to avoid paying their fair share of tax, such activity undermines confidence in our voluntary tax system as well as public support for

charitable giving, a unique and important feature of our society. Curbing ATATs is one of the overall goals of the IRS Strategic Plan and it continues to be a major priority in our 2006 work plan. Through enhanced procedures and new organizational units, we are better able to identify new ATATs. For example, the Data Analysis Unit (DAU) will help identify abusive transactions and trends; our new Touch and Go (TAG) program will identify cases early in the determination process that may involve abusive transactions; and our new Review of Operations (ROO) Unit will follow up on certain organizations within the first three years of having received tax-exempt status.

The following are some of the areas that we will continue to look at:

- **Donor-Advised Funds (DAF):** Donor-advised funds allow private donors to provide input as to how their charitable contributions will be distributed. Though many DAFs are legitimate, a number of organizations have abused the basic concepts underlying donor-advised funds. These organizations are established for the purpose of generating questionable charitable deductions, providing impermissible economic benefits to the donors and their families and providing management fees for the promoters.

In FY 2005, we identified and began examinations of potentially abusive and non-abusive DAFs. In FY 2006, we will complete these examinations, analyze the results and, based on what we learn, we will determine the next appropriate step.

- **IRC Section 509(a)(3) Supporting Organizations:** Significant numbers of abusive 509(a)(3) organizations have been identified by SB/SE, CI and EO. These schemes often include supporting organizations that do not own or control their assets, have made large loans to the founder or supported organization trustees, do not have independent trustees, utilize off-shore companies to hide transactions that result in donations going back to the donor, and do not provide the support for which they obtained exemption. SB/SE identified promoters/investors who were referred to EO to examine the exempt organization involved. In FY 2006, we will continue a cross-functional examination effort.
- **HUD Housing Programs:** HUD referred abuses by individuals setting up exempt organizations to participate in HUD rehabilitation/resale programs. Potential abuses include lack of charitable activity, private benefit to for-profit brokers, personal use of program property, and private benefit provided to related for-profit construction contractors hired to complete the repairs to program properties. In FY 2006, we will continue to address abuses by exempt organizations in HUD's housing rehabilitation/resale program.

In another housing program, we identified potential problems with Exempt Organizations that were established to participate in down-payment assistance programs. During FY 2006, in concert with expected guidance on down payment

assistance, we will focus on ensuring that organizations conform to the new guidance.

- 2. Anti-Terrorism:** EO continues to support government-wide anti-terrorism activities by working with Treasury's Task Force, CI and other law enforcement agencies. In addition, in FY 2005, we began a compliance project involving organizations that make foreign grants. Our objective was to obtain information about the existence and effectiveness of controls used by these organizations to monitor foreign grant distributions and other activities.

In FY 2006, we will complete these examinations, analyze the data, address the need for possible guidance and issue a report. In addition, we will target new organizations for examination based on the analysis from the FY 2005 project. Our new Financial Investigations Unit (FIU) will begin working cases involving complex financial and fraudulent transactions.

We will continue to provide technical assistance on EO law to Treasury's Executive Office for Terrorist Financing and Financial Crimes as well as other inter-agency government task forces. We will assist CI in ongoing investigations of suspect charities, and work with them on a project to help track connections between known or suspected terrorists/terrorist organizations and other individuals and organizations, including exempt organizations. The FIU will provide assistance to other investigative offices in identifying and working fraud and terrorist financing cases.

- 3. Excessive Compensation Initiative:** The Tax Exempt Compensation Enforcement Project was established to address the potential issue of excessive compensation being paid to insiders of charities and private foundations. The initiative addresses such issues as how compensation is determined and reported as well as types of compensation transactions between employees and the organization. In FY 2005, our Exempt Organizations Compliance Unit (EOCU) mailed approximately 1,250 compliance check letters and we started a significant number of field examinations. During FY 2006, we will complete these examinations and issue a report on our initial findings. Based on our findings, we will target additional examinations and compliance checks.
- 4. Credit Counseling:** Addressing abuse in the credit counseling industry continues to be one of EO's highest priorities. As IRS Commissioner Mark Everson explained in his testimony this year before the Senate Finance Committee, some credit counseling organizations have moved from their original purpose of counseling and educating troubled debtors, to inappropriately enrolling debtors in debt-management plans and credit-repair schemes for a fee.

We are making progress in eliminating abusive credit counseling practices. By December 2005, we will have proposed revocations on 20 cases comprising roughly 50 percent of the industry's gross receipts. We are using the information gained from these examinations to screen new applications more effectively. In addition, Form

1023, the application for recognition of tax exemption filed by charities, now includes questions that will help us in identifying potentially abusive organizations.

In FY 2006, the EOCU will assist with compliance resolution for additional credit counseling organizations, including non-filers and filers not previously contacted. We also will continue to work with the Office of the U.S. Trustee to prepare them for an influx of applications from credit-related organizations because of the new Bankruptcy Act, which requires debt counseling before and at the end of bankruptcy proceedings.

Other Compliance Projects

In addition to focusing on our critical initiatives, we will continue work on compliance projects we previously handled as well as general program referrals.

- 1. Medical/Dental Resident FICA Claims:** In FY 2005, Treasury and IRS issued final regulations on the exception from employment taxes for services provided by students when those services are performed for a school, college or university. The final regulations provide standards for determining whether an employer qualifies as a school, college, or university, and whether an employee is a student for purposes of the exception from employment taxes. The final regulations also provide that full-time employees are not students for purposes of the exception. In addition, Treasury and the IRS issued Revenue Procedure 2005-11, which provides a safe harbor for the student FICA exception consistent with the final regulations. Based on the final regulations and the revenue procedure, EO continues to work on resolving its medical/dental FICA claims. These include field examinations, cases fast-tracked to Appeals; erroneous refund suits, or “Line 9 adjustment” cases; and claims that were suspended pending the issuance of the final regulations.
- 2. Credit Unions:** We have approximately 60 state credit union cases in the examination stream. These cases revealed that a majority of these organizations had income from insurance activities, certain ATM fees and other activities that the IRS views as unrelated business income. These organizations either did not file Form 990-T or failed to report the income on Form 990-T. We will consider appropriate options for addressing the issue.
- 3. Tax-Exempt Bonds:** Tax-exempt bonds provide an indirect government subsidy or benefit to 501(c)(3) organizations on whose behalf they are issued. Bondholders of tax-exempt bonds are willing to accept lower interest rates to obtain income exempt from federal tax. Thus, the borrowing costs of 501(c)(3) organizations financing their activities with tax-exempt bonds proceeds are lower. While this benefit is conferred to encourage socially worthwhile endeavors, it also can attract private parties more motivated by the potential of increased profits than insuring that bond proceeds further the organizations charitable purposes.

In FY 2006, we will coordinate with the Tax-Exempt Bond Division’s examinations of 501(c)(3) organizations where potential issues related to tax-exempt status of

bonds are identified. They will review bonds issued on behalf of 501(c)(3) organizations to ensure that transactions do not violate the private benefit rules.

- 4. IRC Section 527 Organizations:** Section 527 organizations are established for the purpose of engaging in political activities. Under section 527 of the Code, certain political organizations must periodically file public disclosure reports with the IRS.

During FY 2005, the EOCU sent contact letters to non-compliant section 527 organizations that filed late, filed an incomplete return, or filed an amended return that was materially different from the original return.

In FY 2006, we will send out compliance check letters to political organizations that have not filed Form 8872 to ensure that these organizations are filing correctly and that our database is accurate. We will then implement a notice process to ensure organizations understand their filing responsibilities.

- 5. Political Activity Compliance Initiative (PACI):** During FY 2005, EO continued examining referrals of alleged political campaign intervention by IRC 501(c)(3) organizations in the 2004 elections. We will complete the majority of cases during FY 2006 and, in the second quarter, we will issue a report summarizing the findings. Revised procedures will be utilized for the 2006 election cycle, which will again address noncompliance and educate organizations about the prohibition on political activity under 501(c)(3). In addition, during FY 2006 we will use information from state election agency databases to contact 501(c)(3) organizations that contributed to political campaigns.
- 6. Disaster Relief:** The focus of this compliance project is to ensure that distributions by disaster relief organizations were made in compliance with the Victims of Terrorism Tax Relief Act of 2001. EO will ensure that there is no private benefit, inurement, or fraud, and that the organizations are fulfilling their exempt purpose.
- 7. Gaming:** Implementation of the multi-year National Charitable Gaming Strategy and Action Plan continues in FY 2006 with activities that include continuing examinations and educational efforts.

EOCU Initiatives

The EOCU will continue its combination of compliance and educational contacts in FY 2006. One potential compliance project will involve sending a questionnaire to a significant number of hospitals asking them to provide information on how they determine and pay compensation as well as how they meet the community benefit standards for purposes of section 501(c)(3). Another project involves sending educational letters to tax-exempt organizations that may be required to file Form 990 electronically beginning in 2006. The letter will explain the requirements and direct organizations to our website for more information. In addition, we plan to contact a significant number of political organizations that have not filed Form 8872.

Guidance

To assist the charitable community in complying with the complex tax laws governing exempt organizations, EO, in conjunction with the Office of Chief Counsel and the Department of Treasury, will develop and issue guidance to customers.

The FY 2006 Priority Guidance Plan includes:

- Guidance on donee reporting for car donations
- Guidance on down-payment assistance organizations
- Guidance under section 501(c)(15)
- Guidance under section 527(l)
- Regulations under section 529 regarding qualified tuition programs

Market Segment Studies

The market segment approach is based on the recognition that the tax-exempt community consists of diverse segments with unique needs. Studies are designed to measure the level of compliance within a given market segment, and to identify potential areas of non-compliance. Given the emphasis on enforcement, we will not initiate any new market segment studies in FY 2006. However, we will continue the private foundation and community foundation studies described in our FY 2005 Implementing Guidelines, until their conclusion. We also expect to finalize other market segment reports for projects completed in FY 2005.

Other Projects

1. **Federal-State Relations:** EO will continue efforts to streamline and implement a revitalized state sharing program, partnering with the National Association of State Charitable Officials (NASCO) to identify additional areas of mutual interest and explore ways to integrate our activities and strategies.

We will continue to work with our state partners to develop and deliver, in January 2006, the capability for exempt organizations to file Forms 990 and/or state registration forms through a single transmission (Single Point Filing). This will enhance customer satisfaction by providing a capability that our customers, partners, and stakeholders have requested. Enabling Federal/State e-filing will reduce taxpayer burden, increase the number of electronically filed returns received, and increase the amount of data available for enforcement efforts.

2. **Legislation:** We will review and provide input on proposed legislation related to exempt organizations, in conjunction with Legislative Affairs, Counsel and Treasury. As needed, we will develop implementation and communication plans for any new legislation.

3. **Form 990 Revision:** To further the goals of increasing transparency and obtaining enhanced compliance data, in FY 2006, EO will continue to work on a comprehensive overhaul of Form 990.
4. **TEGE Determination System (TEDS):** EO will provide extensive technical expertise for the development of TEDS to replace current methods for processing and tracking determination application cases.
5. **Cyber Assistant:** EO will continue to provide specialized knowledge and skill for the development of an interactive application for completing Form 1023. The program will use a “Cyber Assistant” to guide the applicant through Form 1023. Cyber Assistant will define essential and unfamiliar terms, require the completion of certain information to assure a complete application, and perform consistency checks.

Customer Education and Outreach

In FY 2006, EO will continue to emphasize education and outreach to the exempt organizations community. Due to limited resources, we will reduce our face-to-face contacts but actually expand the total number of contacts through EO listserv, phone forums, and the development of web-based training modules. Our activities will fall into three broad categories: publications and forms, presentations, and web-based programs.

1. **Publications and Forms:** During FY 2006, we will continue working on the plain language publications initiated in FY 2005, including a brochure on political activity and revision of the two car donation publications.

In conjunction with reviewing and editing EOCU letters, we will develop mini-publications when we become aware of a new or developing issue or a possible area of noncompliance that may impact the operations and compliance responsibilities of our EO customers.

2. **Presentations:** EO will continue to participate in the IRS Tax Forums, a three-day session offered annually in six locations around the country. We will coordinate EO seminars and workshops at the Forums and jointly sponsor a booth with other TE/GE offices.

We will continue to provide workshops for small and mid-size exempt organizations in cities throughout the country. In addition, we will develop web-based training modules of parts of this workshop. The workshops are designed to help representatives of these organizations understand their basic tax compliance responsibilities.

In FY 2005, we experimented with using a phone forum as a means of providing information to the tax-exempt community on the revised Form 1023. Participant response was overwhelmingly positive, therefore, we will expand our use of phone forums, which will allow us to reach more organizations using fewer resources.

EO receives over 200 invitations annually to speak at meetings, conferences, serve on panels or at other events. We will coordinate these speech invitations and assist speakers with preparation and editing of speeches. In addition, we will proactively seek speaking opportunities to large audiences that further EO's FY 2006 compliance priorities.

- 3. Web-Based Programs:** EO recognizes that continued expansion of the quality and quantity of information on irs.gov will help exempt organizations comply with the tax laws.

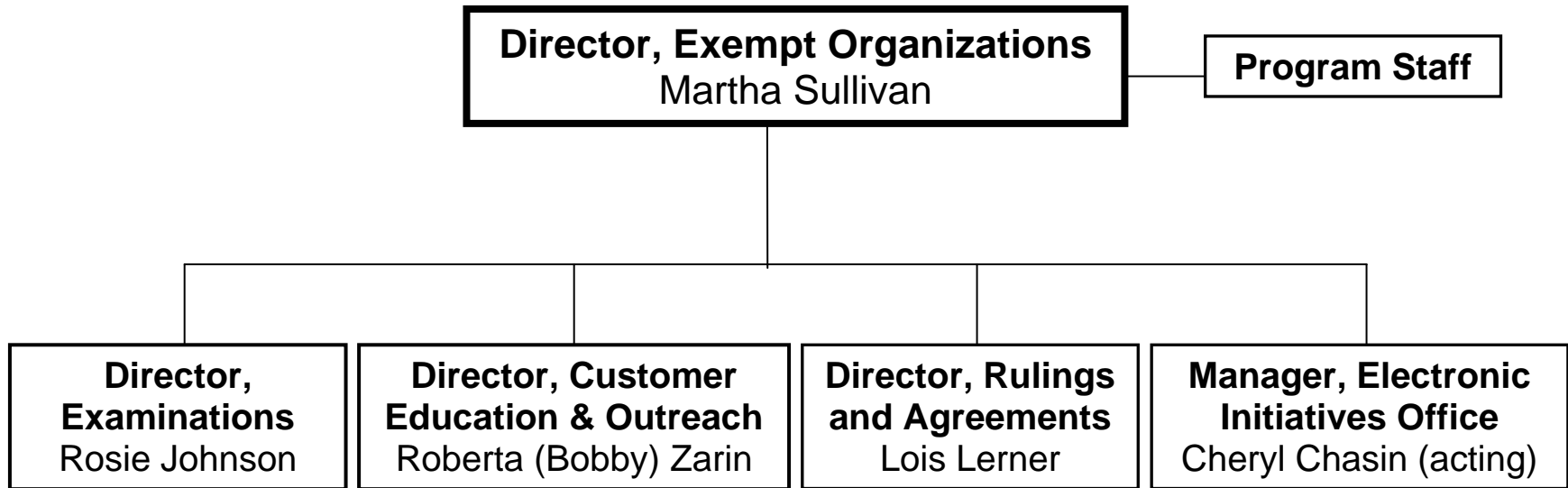
In FY 2006, we will redesign the Charities and Non-Profit pages of irs.gov, concentrating on improving the structure and accessibility. We will develop web-based training modules based on our popular Small and Mid-Size Exempt Organizations workshop. This will allow us to provide this information to a greater number of individuals using fewer resources.

Electronic Initiatives

EO will continue its involvement in electronic initiatives including e-file, exploring opportunities to increase data availability, improving research and analytical systems, and working with other divisions to identify new data sources.

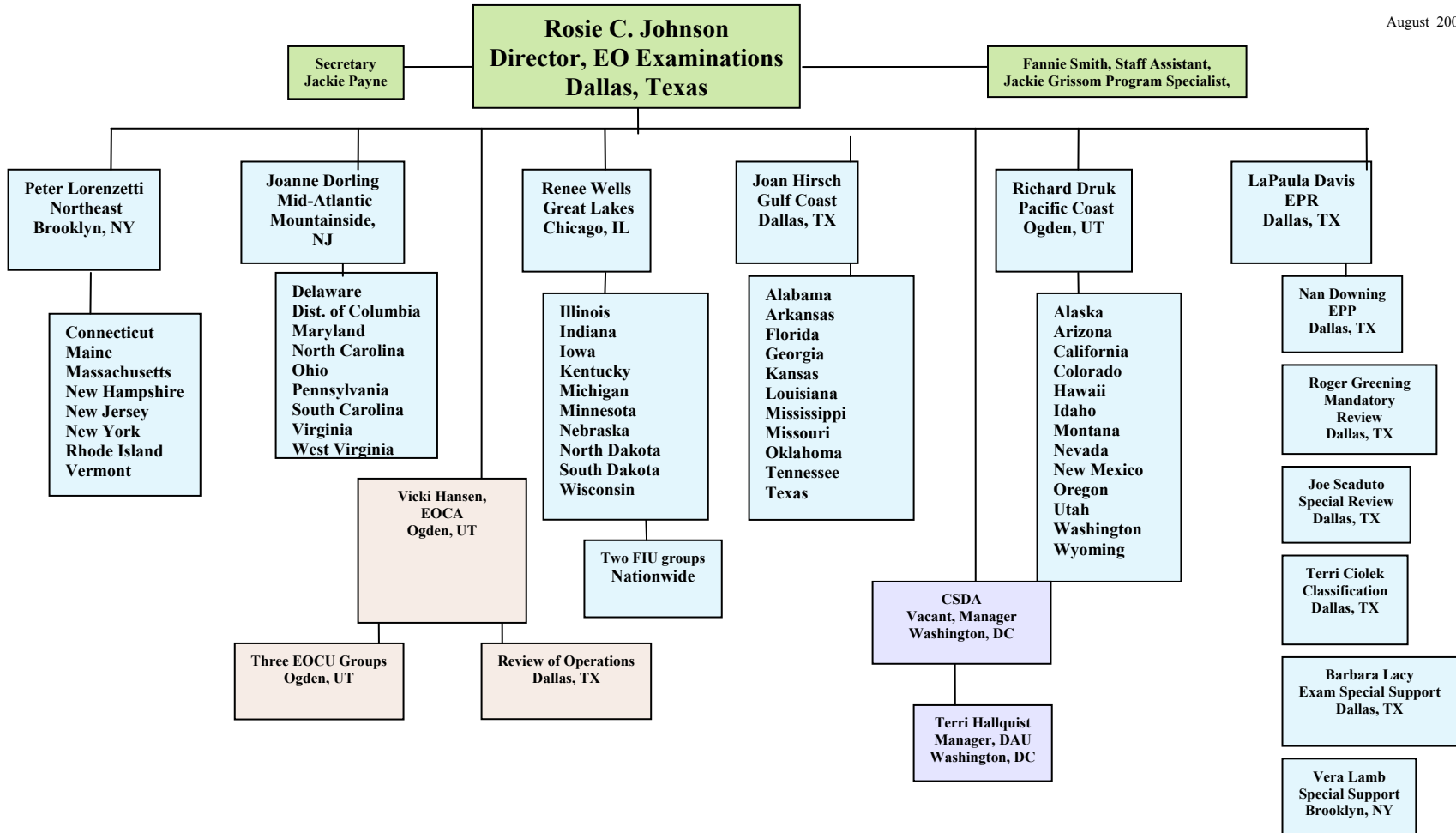
- 1. Risk Modeling:** We will develop a risk model for case selection in one or more specific categories. The model will leverage our current databases as well as modernized e-file technology to track specific data elements on the Form 990. Use of this model will allow EO to select more productive or non-compliant examination cases, thereby reducing taxpayer burden and using EO's limited resources more effectively.
- 2. Accelerated Case Building Project:** In FY 2006, we will develop and implement a new initiative that will provide compliance support tools to all TE/GE enforcement personnel enabling them to navigate through research and analytical data assimilated from various sources.
- 3. Modernized e-File (MeF):** We will continue to improve the availability of electronically filed Form 990 information returns, and support the imaging of paper EO filings, to expedite the disclosure of exempt organization filings. In FY 2006, we will:
 - Release Federal/State Single Point Filing.
 - Support the delivery of procedures, guidelines, waiver requirements, and customer communications to ensure the successful implementation of the Form 990 electronic filing requirements.

In conclusion, we are committed to our mission of helping exempt organization customers understand and comply with the tax laws while protecting the public's interests. To this end, we will continue to emphasize balancing enforcement with educational and outreach efforts. We look forward to working with all of our stakeholders to achieve the goals we have set for FY 2006.



EO Examination Organizational Chart

August 2005



EO R&A Organizational Chart

