

Advisory Committee on
Tax Exempt and Government Entities
(ACT)

V. The “**RIPPLE**” Project

**Reviewing IRS Policies and Procedures to Leverage
Enforcement:**

*Recommendations to Enhance Exempt Organization’s
(EO) Enforcement and Compliance Efforts*

"If we do not act to guarantee the integrity of our charities, there is a risk that Americans will lose faith in and reduce their support more broadly for charitable organizations, damaging a unique and vital part of our nation's social fabric."

IRS Commissioner Mark W. Everson
March 30, 2004

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June 9, 2004

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I. EXECUTIVE SUMMARY

Over the past decade, the number of exemption applications filed with the IRS's Exempt Organization Division (EO) has steadily increased each year and reached an all-time high of 91,439 in 2003. As a result, there are now over 1,640,949 exempt organizations and over 964,418 of these have been granted 501(c)(3) status as either public charities or private foundations. Even though the number of organizations granted exempt status has increased dramatically over the years, EO staffing levels have remained essentially static.

To deal with the ever-growing number of determination requests, over the last several years examination personnel have been reassigned to the determination process so that these requests for exempt status could be evaluated in a more timely manner. Even though this reassignment of personnel ceased sometime ago, it has resulted in the percentage of the EO workforce devoted to the determination function reaching historically high levels, while leaving significantly fewer employees dedicated to the examination function. In fact, partly because of this reassignment of personnel, EO's examination rate has, for some time now, fallen below 1 percent.

With such a low examination rate, it is widely believed that the current EO compliance presence is not sufficient to guarantee appropriate attentiveness by the exempt organization community or to engender confidence among contributors and others that credible oversight of the sector exists. In fact, during the last several years, many articles in both the mainstream press and specialized publications for the exempt organization community have questioned the ability of both state regulators and EO to monitor the exempt sector effectively. In addition, two years ago the General Accounting Office (GAO) concluded in a highly-publicized report that both state regulators and EO were not doing an adequate job of overseeing the sector.

Given this widespread perception of insufficient state and federal oversight of the exempt sector, it is imperative that EO explore ways to enhance its enforcement and compliance efforts so that public confidence in both EO's effectiveness and in the exempt sector itself can be increased. The public's confidence in, and support of, the sector increases when it perceives there is effective monitoring and oversight by state and federal regulators, and decreases when it perceives that monitoring and oversight are minimal and ineffective. As a result, state regulators and EO each play vital roles in maintaining confidence in the exempt sector. EO plays a particularly important role because it is the governmental entity responsible for ensuring that only qualified organizations are granted, and retain, exempt status. In this capacity, EO plays a crucial "clearinghouse" role in helping assure the donating public that organizations granted exempt status are legitimate and worthy of support. Contributors, exempt organizations, and their professional advisors need to feel confident that EO thoroughly reviews applications for exempt status; routinely reviews exempt organization annual Form 990 returns; investigates questionable returns and organizations; and ensures that those who intentionally falsify these returns or otherwise violate the law are punished appropriately.

Our recommendations are intended to help EO enhance its enforcement and compliance efforts by increasing its “presence” in the exempt organization community. This objective is consistent with one of the primary objectives of IRS Commissioner Everson to enhance the overall effectiveness of IRS enforcement and compliance in all areas of responsibility. As EO implements each of our recommendations, there will be an ever-widening “ripple” effect throughout the exempt organization community as EO’s enhanced enforcement and compliance efforts become more widely known. As each recommendation is implemented, both the reality and perception that EO is more effectively overseeing the sector will increase --- much like a single stone tossed into the water has an ever-widening or “ripple” effect on the water into which it is thrown.

As will be seen from many of our recommendations, EO will be able to enhance its enforcement and compliance efforts by utilizing technological advances and other means to help its staff work more effectively and efficiently. However, given the explosive growth of the exempt sector over the last several decades, there is no getting around the fact that significant staff increases will also be required if EO is to do a truly credible job of overseeing this rapidly-expanding and vital sector of our economy.

Therefore, with the ultimate goal of increasing public confidence and trust in the exempt sector, we offer the following recommendations to enhance EO’s enforcement and compliance efforts:

EXAM-RELATED RECOMMENDATIONS: An essential element of any oversight agency’s enforcement and compliance program is its ability to effectively select for more detailed review those organizations that are likely to be noncompliant or otherwise violating the law. Therefore, EO should improve its case selection efforts and develop an ongoing feedback process for continuous refinement of its selection criteria. In addition, EO should increase the number of “limited scope” audits and targeted “soft contacts” within the exempt organization community.

PUBLICITY-RELATED RECOMMENDATIONS: An essential element of any oversight agency’s enforcement and compliance program is its ability to effectively publicize the results of its enforcement efforts and the types of compliance issues about which it is concerned. Therefore, EO should improve publicity regarding its enforcement efforts and compliance concerns. In addition, EO should publicize widely the availability and advantages of electronic filing of Form 990 and encourage exempt organizations to utilize this option.

STAFF-RELATED RECOMMENDATIONS: An essential element of any oversight agency’s enforcement and compliance program is its ability to recruit and retain sufficient numbers of well-trained, experienced staff to conduct its oversight responsibilities. Therefore, the IRS should follow through with its commitment to hire 72 additional EO examination agents and should improve

and enhance its current training and education programs for agents and examiners.

PUBLIC EDUCATION RECOMMENDATIONS: An essential element of any oversight agency's enforcement and compliance program is its ability to regularly educate the organizations it oversees so that the organizations can ensure they are in compliance with all applicable laws, rules, and regulations. Therefore, EO should increase its issuance of technical and precedential guidance and increase the number and technical content of its public presentations and other educational initiatives.

CONSEQUENCE-RELATED RECOMMENDATION: An essential element of any oversight agency's enforcement and compliance program is its ability to encourage compliance by regularly documenting and pursuing significant violations of the laws, rules, and regulations the agency is responsible for enforcing. Therefore, EO should increase the consequences for both individuals and organizations that intentionally submit false Form 990 returns or otherwise violate the law.

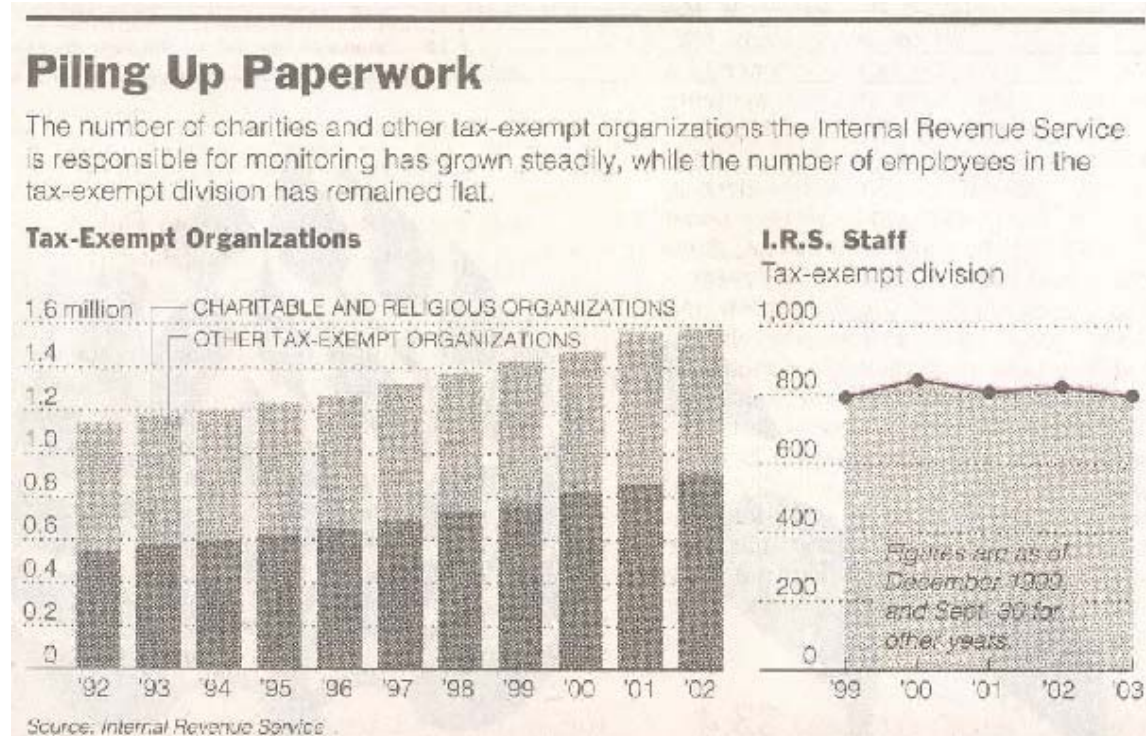
ENFORCEMENT-RELATED RECOMMENDATIONS: An essential element of any oversight agency's enforcement and compliance program is its ability to encourage voluntary compliance and to coordinate its efforts with state and federal agencies that have similar enforcement responsibilities. Therefore, EO should implement a formal voluntary compliance program and vigorously support amendment of Section 6103 of the Internal Revenue Code.

II. BACKGROUND

At our June 21, 2002 public meeting, we recommended installation of Life Cycle of a Public Charity and Life Cycle of a Private Foundation webpages on the IRS website as a means of providing access to narrative explanations and applicable forms and instructions relating to significant events in the "life" of a charity. At our May 21, 2003 public meeting, we offered a range of recommendations to improve the EO determination process. Some of these recommendations, notably the development and posting of a fully interactive Form 1023 ("CyberAssistant"), were logical extensions of our earlier Life Cycle recommendations. In our May 2003 report, we expressed our belief that streamlining the EO determination process would enable EO to increase its focus on compliance, an essential function in maintaining the integrity of the exempt sector.

Over the past decade, the number of exemption applications filed with EO each year has steadily increased. It reached an all-time high of 91,439 in 2003. There are now over 1,640,949 exempt organizations and over 964,418 of these have been granted 501(c)(3) status as either public charities or private foundations. The following charts show that, even though the number of organizations granted exempt status has increased dramatically over the years, EO staffing levels have remained essentially

static.



To deal with the ever-growing number of determination requests, over the last several years EO management has reluctantly reassigned examination personnel to the determination process so that the voluminous requests for exempt status could be evaluated in a more timely manner than would otherwise have been possible. This reassignment of examination personnel ceased in February of 2003. However, the earlier reassignments resulted in the percentage of the EO workforce devoted to the determination function reaching historically high levels, while leaving significantly fewer employees dedicated to the examination function. In fact, partly because of this reassignment of personnel, EO's examination rate has, for some time now, fallen below 1 percent.

In a voluntary tax system, compliance must necessarily rely upon perception and deterrence, with appropriate oversight by both federal and state regulators. Even though most individuals and organizations comply with the tax laws because it is "the right thing to do", the unfortunate reality is that many "voluntarily" comply only because they believe that, if they don't, there is a substantial likelihood they will eventually get caught and have to pay significant penalties. With an examination rate below 1%, it is widely believed that the current EO compliance presence is not sufficient to guarantee appropriate attentiveness by the exempt organization community or to engender confidence among contributors and others that credible oversight of the sector exists. During the last several years, there have been many articles questioning the ability of

both state regulators and EO to monitor the exempt sector effectively.¹ For example, according to a recent *New York Times* article:

*“America has the world’s biggest collection of charities, but oversight of the nonprofit sector is parochial, piecemeal, political and, at times, accidental. In the last decade, gaps in a regulatory system that could be described as more hole than net have widened, as the number of charities and their assets exploded and state and federal money spent monitoring them remained flat or declined.”*²

This is typical of the kind of publicity state regulators and EO receive concerning their enforcement efforts in both the mainstream press and specialized publications for the exempt community. In addition, two years ago, the U.S. Senate Finance Committee asked the General Accounting Office (GAO) to conduct a detailed review of EO’s effectiveness in monitoring and overseeing the exempt sector. In its highly-publicized April 2002 report, the GAO concluded that both state regulators and EO were not doing an adequate job of overseeing and policing the sector.³

Given this widespread perception of insufficient state and federal oversight of the exempt sector, it is imperative that EO explore any and all ways to enhance its enforcement and compliance efforts so that public confidence in both EO’s effectiveness and in the exempt sector itself can be increased. Numerous surveys, studies, and articles have recently chronicled a significant decline in donor confidence that, if not addressed and reversed, could have serious, long-term consequences for the sector.⁴

It is critical that the public feel confident that the exempt sector is comprised of legitimate, fiscally-prudent, and accountable organizations that provide valuable services. The public’s perception of the sector must be positive to ensure continued support. The entire sector is tarnished whenever there are scandals or serious questions about the integrity, credibility, or effectiveness of certain exempt organizations. Indeed, Independent Sector, the largest membership group for exempt

¹ See, “A Challenge for the IRS”, *The Chronicle of Philanthropy*, Volume XIII, Number 21, August 23, 2001.

² “New Equation For Charities: More Money, Less Oversight”, *The New York Times*, November 17, 2003.

³ “Tax-Exempt Organizations: Improvements Possible in Public, IRS, and State Oversight of Charities”, GAO Report to the Chairman and Ranking Minority Member, Committee on Finance, U.S. Senate, GAO-02-526.

⁴ See “Nonprofits Show Losses in the Public’s Trust”, *The Washington Post*, September 10, 2002; “42% Of Americans Say Relief Effort Damaged Faith In Nonprofit Groups”, *The Chronicle of Philanthropy*, September 5, 2002; Paul C. Light, “Trust in Charitable Organizations”, a Brookings Institution policy brief published in December 2002; “Public Confidence in Charitable Organizations Continue to Lag, Report Finds”, *The Chronicle of Philanthropy*, December 11, 2003, page 27; “To Give or Not to Give: The Continued Crisis in Charitable Confidence”, a Brookings Institution policy brief published in December 2003, www.brookings.org; “Survey Identifies Troubling Trends for Nonprofit Organizations”, *The Chronicle of Philanthropy*, November 14, 2002.

organizations in the United States, has correctly noted that, “[p]ublic trust is the single most important asset of the [exempt] community. Without it, donors will not give and volunteers will not get involved.”⁵ As the opening quotation to this report indicates, IRS Commissioner Mark W. Everson shares this view.

Equally important, the public’s confidence in, and support of, the sector increases when it perceives there is effective monitoring and oversight of the sector by state and federal regulators, and decreases when it perceives that monitoring and oversight are minimal and ineffective. As a result, state regulators and EO each play vital roles in maintaining confidence in the exempt sector. EO plays a particularly important role because it is the governmental entity responsible for ensuring that only qualified organizations are granted, and retain, exempt status. In this capacity, EO plays a crucial “clearinghouse” role in helping assure the donating public that organizations granted exempt status are legitimate and worthy of support. Contributors, exempt organizations, and their professional advisors need to feel confident that EO thoroughly reviews applications for exempt status; routinely reviews exempt organization annual Form 990 returns⁶; investigates questionable returns and organizations; and ensures that those who intentionally falsify these returns or otherwise violate the law are punished appropriately.

Because we believe public trust and confidence in the exempt sector needs strengthening, our recommendations are intended to help EO enhance its enforcement and compliance efforts by increasing its “presence” in the exempt organization community. This objective is consistent with one of the primary objectives of IRS Commissioner Everson to enhance the overall effectiveness of IRS enforcement and compliance in all areas of responsibility. As EO implements each of our recommendations, there will be an ever-widening “ripple” effect throughout the exempt organization community as EO’s enhanced enforcement and compliance efforts become more widely known. As each recommendation is implemented, both the reality and perception that EO is more effectively overseeing the sector will increase --- much like a single stone tossed into the water has an ever-widening or “ripple” effect on the water into which it is thrown.

III. PROJECT FOCUS

The decision to focus our third EO project on the EO examination process is a logical progression from our two previous EO projects. Because it appeared at the

⁵ “Obedience To The Unenforceable: Ethics and the Nation’s Voluntary and Philanthropic Community” (2002), Independent Sector, www.independentsector.org.

⁶ Form 990 returns are detailed annual informational returns that report an organization’s revenue, expenses, and other key operational information. Most exempt organizations are required to file a Form 990. These annual returns are public documents and include: Form 990s that are filed by the majority of exempt organizations, Form 990EZs that are filed by exempt organizations with annual revenues under \$100,000, and Form 990PFs that are filed by private foundations.

outset of this particular project that EO enforcement staffing levels were not likely to increase, we concentrated our efforts on identifying ways in which EO could enhance its enforcement and compliance efforts utilizing existing resources and personnel. However, as of the date of this report, it appears EO will be able to hire as many as 72 additional examination agents by the end of the 2004 fiscal year.⁷ If this occurs, these new agents will enhance EO's compliance presence by increasing both the number and quality of the examinations that can be conducted. We strongly urge the IRS to follow through with its commitment to hire these additional EO examination agents by the end of the 2004 fiscal year, or sooner.

Whether these agents are added or not, it remains critical that EO management and staff continuously strive to create both the reality and perception of increased EO oversight in order to strengthen public confidence. There needs to be both the reality and perception that there is greater enforcement within the sector and that the likelihood of violators being caught and punished appropriately has increased. It was a recurring theme among EO practitioners interviewed for this project that EO needs to regularly make examples of exempt organizations and their principals who ignore the law.

These practitioners consistently commented about how frustrating it is for them to advise their clients to "do things the right way" and have so many respond that to follow the practitioners' advice would not only be more costly but, more importantly, that EO never seems to do anything to those who consistently fail to "do things the right way". These practitioners strongly recommended that EO aggressively pursue those organizations and individuals who ignore IRS requirements with apparent impunity so that their clients would take the practitioners' recommendations seriously. As will be seen from many of our recommendations, EO should be able to make significant strides to address these concerns by utilizing technological advances and other means to help EO examination personnel work more effectively and efficiently. However, given the explosive growth of the exempt sector over the last several decades, there is no getting around the fact that significant staff increases will also be required if EO is to do a truly credible job of overseeing this rapidly-expanding and vital sector of our economy.

IV. PROJECT PROCESS

In September 2003, we started our work on this project by interviewing several key individuals responsible for EO's current enforcement and compliance efforts. These individuals included: Rosie Johnson, Director, EO Examinations; Jo Ellen Dudycha, Central Mountain Area Manager; Mike Murphy, TEP Project Manager; Anita Sutherland, Manager, EO Classification; Dee Weise, Management Official; and Joanne Dorling, Mid-Atlantic Area Manager. We asked each to explain the current enforcement and compliance efforts for which he or she is responsible. Equally important, we asked each to assess the effectiveness of his or her current efforts and identify how they could

⁷ Because EO has not been able to fill existing vacancies for some time now, its overall staffing levels will only increase by approximately 50 after these 72 positions are added.

be improved both within existing resource constraints and should additional resources become available. Based upon these interviews, we also reviewed appropriate statistical and other documentation to help determine the extent and effectiveness of EO's current enforcement and compliance efforts.

We also formally solicited input from both the American Bar Association's Tax Section Committee on Exempt Organizations (ABA Committee) and the National Association of State Charity Officials (NASCO) concerning EO's current enforcement and compliance efforts and how they could be improved. ACT member Karl Emerson wrote an article for *The Pennsylvania Nonprofit Report* describing this project and soliciting input from that publication's readership. Fred Stokeld of *Tax Analysts* also wrote an article about this project and encouraged readers to submit comments and suggestions. We also sought input from the American Institute of Certified Public Accountants (AICPA), the American Society of Association Executives (ASAE), the Council on Foundations, the Pennsylvania Bar Association's Charitable Organization Committee, and various state Attorneys General Offices.

In October 2003, we interviewed other EO personnel including: Steve Miller, Director, Exempt Organizations; Clint Siemens, Management & Program Analyst (Retired); Lois Lerner, Director, EO Rulings; Bobby Zarin, Director, EO Customer Education & Outreach; Midori Morgan-Gaide, Manager, Electronic Initiatives Office; and Donna Hockensmith, Management & Program Analyst. We also reviewed additional background documentation, including a complex chart that detailed the current EO case selection process.

On January 12 and 13, 2004, we interviewed Steven Pyrek, TE/GE Director of Communications and Liaison; Jennifer Whaley, Communication and Education Public Information Officer, who is in charge of publicity for the IRS Criminal Investigation Division; and Terry Lemons, IRS National Press Secretary, to discuss current efforts to publicize EO enforcement results and how they could be improved. We also interviewed Michael Julianelle, Director of the TE/GE Exam Redesign Project.

On January 30, 2004, ACT members Deirdre Dessingue, Karl Emerson, and Victoria Bjorklund participated in a presentation at the winter meeting of the ABA Committee and received input and suggestions for enhancing EO's enforcement and compliance efforts. Additional input was received from various members of the ABA Committee at its May 7, 2004 meeting in Washington, D.C.

Between January and April 2004, we interviewed various EO practitioners, a number of whom were former IRS officials, including: Ed Coleman, Alan Dye, Jay Rotz, Art Herold, Doug Mancino, Evelyn Brody, Marc Owens, and Celia Roady.

At our final working session in April 2004, we interviewed Paul Streckfus, Editor of *The EO Tax Journal*, to solicit his input about how EO's enforcement and compliance efforts could be enhanced. We were also briefed a second time by Michael Julianelle regarding the progress and findings of his extensive review of the entire TE/GE

examination process.

The informal input as well as any formal responses received from these individuals and organizations were all reviewed and incorporated, where appropriate, into this final report. We thank all who took time to give us their valuable input and suggestions.

V. EO's Current Examination Process

Currently, EO's examination program consists of the following:

General Compliance Examination Program. A general compliance examination involves a comprehensive review of an organization's management, activities and finances. This type of examination is usually conducted at the organization's offices. It may involve one or more agents and usually requires a considerable expenditure of both human and economic resources by EO and by the organization.

Large Case Program. The large case program generally involves full-scope, comprehensive audits of large exempt organizations, e.g., colleges, universities, and healthcare institutions. These audits likewise require a significant expenditure of human and economic resources on both sides.

Limited-Scope Examination Program. In its limited-scope examination program, EO identifies in advance one or more specific items on certain organizations' Form 990s and requests additional information only about those particular items. This may be accomplished through correspondence or by personal contact by an EO agent. Authorization is required to proceed beyond those issues.

Correspondence Exam Program. Correspondence examinations are desk audits in which the agent does not physically visit the exempt organization but, instead, simply requests certain documentation relevant to the particular, limited issues the agent is examining.

Market Segmentation Program. This is a relatively new initiative in which EO is examining various segments of the exempt sector to determine common areas of concern and noncompliance within each sector. EO takes statistically significant samples within each sector and then conducts comprehensive examinations of the selected organizations to determine the types of compliance issues unique to that particular sector. EO intends to publish the results of each market segment study to encourage other organizations within the sector to come into compliance voluntarily. These market segment examinations have been very labor and resource intensive and, to date, none have been completed.

Exempt Organizations Compliance Unit (EOCU). The EOCU is a new 15-person unit established in February 2004 and headquartered in Ogden, Utah. The EOCU primarily focuses on "soft contacts", ranging from educational initiatives to

correspondence exams, including follow-up on market segment cases. Case selection is directed from Dallas. The EOCU will work closely with the new Data Analysis Unit (DAU) that is scheduled to start up in the summer of 2004.

VI. Recommendations

After reviewing interview notes, documentation gathered, and comments and suggestions submitted by all interested parties, we offer the following recommendations to enhance EO's enforcement and compliance efforts with the ultimate goal of increasing public confidence and trust in the exempt sector.

EXAM-RELATED RECOMMENDATIONS: *An essential element of any oversight agency's enforcement and compliance program is its ability to effectively select for more detailed review those organizations that are likely to be noncompliant or otherwise violating the law.*

1) EO Should Improve Its Case Selection Efforts And Develop An Ongoing Feedback Process For Continuous Refinement Of Its Selection Criteria.

EO's current case selection efforts yield an overall "no change"⁸ rate of approximately 50%. Although a significant percentage of "no change" results is expected and desired for any state or federal oversight agency, EO's current 50% rate suggests that its case selection criteria need to be adjusted. Like any regulatory agency with limited resources, EO cannot be expected to catch all violators, but can always do a better job of selecting the cases it pursues. Key elements for improving EO's case selection should include the following:

Improved information gathering from all sources. EO's current procedures for selecting exempt organizations for examination can be improved by more effectively utilizing readily available sources of information such as media reports, more sophisticated analysis of Form 990 returns, and other means to more effectively select those cases where there is a higher likelihood of detecting material violations. The ACT wholeheartedly endorses the steps EO has recently taken to improve its case selection efforts by creating the new Exempt Organization Compliance Unit (EOCU) in February 2004 and Data Analysis Unit (DAU) that is scheduled to begin operations later this summer. In addition, since EO currently has the resources to enter only 25 percent of the Form 990 line items into the database used to select cases for examination, we likewise endorse EO's recent decision to acquire additional data from other sources.

The Form 990 is the key document used by both state and federal regulators to oversee and monitor the operations of exempt organizations. Like any form, it can be improved. EO has an experienced team working on a major revision of this document. To date, EO has received extensive written comments and suggestions to improve this

⁸ "No change" means that no material violations were uncovered during the course of EO's audit or examination.

key form from the ABA Committee, AICPA, NASCO, and many other individuals and organizations. By incorporating many of the suggestions made by these individuals and organizations, EO will be able to improve the usefulness of the Form 990 as an enforcement and compliance tool. The EO members of the ACT have also provided, and will continue to provide, regular input and suggestions to this team, as well as to another team that has been working to revise the Form 1023 which EO uses in its initial evaluation of whether an organization is entitled to exempt status.

Because of the critical role the Form 990 plays in both federal and state oversight efforts, we recommend that EO establish a standing Form 990 review committee that would include representatives from NASCO. This standing committee should continuously evaluate the quality and utility of the information being submitted on Form 990 and revise the form appropriately. The committee should also take into account emerging trends and new compliance initiatives so that the Form 990 can serve as a more effective compliance tool.

Increased follow up on reports from the media and public. EO should focus more of its compliance efforts on reports in the media regarding potential violations in the exempt sector. One of the many functions to be performed by EO's new Data Analysis Unit (DAU) will be to search both national and local media sources daily for stories about alleged violations by exempt organizations, their officers, directors, or employees so that EO can promptly take appropriate follow-up action. While it is unrealistic to expect EO to uncover every case of exempt organization fraud and abuse, it is not unreasonable to expect EO regularly to uncover, document, and take appropriate action against those individuals and organizations that engage in the most egregious types of fraud and abuse --- especially in cases that receive widespread media coverage. At minimum, EO should routinely request written explanations from exempt organizations about which the media report serious allegations of wrongdoing. By promptly following up on all media stories alleging significant exempt organization abuses, EO should improve its case selection criteria and results.

In addition, EO should establish a dedicated "portal" to facilitate the reporting of potential violations by the public and the media. This "portal" should include a toll-free complaint line as well as the ability to file complaints through the EO website.

Improved ability to track performance measures and results. EO, like any regulatory agency, needs to improve its ability to track and measure the results of its examination efforts so it can determine whether these efforts have improved compliance within the sector. This feedback is essential for any regulatory agency to refine its case selection criteria on an ongoing basis. For example, the information gathered through EO's current market segment studies should be thoroughly analyzed as soon as possible after their completion to determine whether these resource-intensive projects have been worthwhile and should be continued. EO should continue its practice of having teams of experienced managers regularly evaluate the results of its examinations and lessons learned, particularly after the completion of any significant compliance initiatives. The results of these reviews should be shared regularly not just

within EO, but also with stakeholders and the exempt organization community at large. EO also needs to routinely evaluate its case quality and turnaround time to determine how they can be improved. EO's examination program is currently being thoroughly reviewed and evaluated as part of TE/GE's review of all its examination programs. Because the progress and preliminary findings of this review have been shared with the ACT on an ongoing basis and because the review is scheduled to be completed later this month, we have not included specific recommendations on these particular issues. All suggestions we received for improving the quality and turnaround time for EO examinations have been reviewed with Michael Julianelle, the IRS official in charge of conducting this comprehensive review of the entire TE/GE examination program.

2) EO Should Increase The Number Of "Limited Scope" Audits And Targeted "Soft Contacts" Within The Exempt Organization Community.

Given its resource constraints and the explosive growth of the exempt sector, EO will be able to comprehensively audit each year only a small percentage of the 1,640,949 exempt organizations. Therefore, to increase its presence within the sector, EO needs to increase the number of "limited scope" audits it performs as well as the number of targeted "soft" contacts it makes each year. This effort will increase the number of organizations "touched" and enhance both the reality and perception of increased enforcement.

In fact, EO has already begun to implement this recommendation with the creation of its new Exempt Organization Compliance Unit (EOCU) that specializes in developing innovative types of "soft" contacts that will henceforth be made routinely by EO. We commend this effort and encourage expansion of this initiative to target more effectively areas of potential noncompliance. For example, technology now enables EO to easily identify and contact organizations that report significant contributions but no fundraising expenses and request detailed written explanations of these apparent discrepancies.⁹ Such targeted contacts can be accomplished with significantly fewer resources than are typically expended on a single comprehensive audit and "touch" thousands of organizations instead of just one. Similar types of "soft" contacts should be developed in order to show the exempt organization community and its advisors that EO does regularly examine Form 990s and follow up on apparent discrepancies and irregularities. By implementing this recommendation, EO will significantly enhance its "presence" in the exempt organization community. As soon as EO starts acquiring more comprehensive Form 990 data, it will be able to develop and implement many more of these cost-effective "soft" contacts.

⁹ In fact, the newly-formed EOCU has recently undertaken this particular project based, in part, upon a *Chronicle of Philanthropy* article from several years ago that documented that as many as one quarter of all the organizations reporting contributions of over \$500,000 may have falsely reported that they had no fundraising costs. See, "Charities' Zero-Sum Filing Game", *The Chronicle of Philanthropy*, Volume XII, Number 15, May 18, 2000.

PUBLICITY-RELATED RECOMMENDATIONS: *An essential element of any oversight agency's enforcement and compliance program is its ability to effectively publicize the results of its enforcement efforts and the types of compliance issues about which it is concerned.*

3) EO Should Improve Publicity Regarding Its Enforcement Efforts And Compliance Concerns.

Historically, EO has not emphasized publicity as a compliance tool; however, this has begun to change. For example, last year front-page articles in *The New York Times*¹⁰ and elsewhere detailed potential abuses among credit counseling agencies and EO efforts, along with state regulators and the FTC, to deal with abuses and to alert members of the public. In a particularly creative effort, a letter regarding abusive credit counseling agencies from Commissioner Everson was published in the *Dear Abby* column, reaching millions of readers who would otherwise have remained uninformed about these abuses. In another example, on April 16, 2004, *The Chronicle of Philanthropy* ran an article explaining how EO had “declared illegal a tax scheme under which charities and other tax-exempt groups helped companies avoid taxes through fraudulent charitable donations.” This sort of positive publicity concerning EO enforcement efforts not only deters wrongdoing, but also serves to reassure the donating public that there is credible oversight by EO.

EO currently publishes its annual “work plan” or “implementing guidelines” which outline, for both EO examiners and the entire exempt organization community, those areas of compliance that will be of particular concern in the coming year. This publicity has been an excellent means by which EO has leveraged its resources. Issues identified in the “work plan” each year are widely discussed throughout the exempt organization community and among knowledgeable EO practitioners. Because most exempt organizations want to be in compliance and will generally conform their conduct and operations to do so, EO should continue to use this effective means of communication.

In addition to publicizing areas of compliance emphasis and concerns for the coming year, EO should begin reporting annually, on at least an aggregate basis, *the results* of its examination efforts and other compliance initiatives. For example, EO should widely publicize, on its website and otherwise, the “Top 10” types of violations it documented during the past year as well as the “Top 10” Form 990 errors it found. Areas of noncompliance highlighted in this annual report should also be used to develop a monthly compliance “tip” that would be posted on the EO web page. This “tip” feature should involve a short discussion of a particular compliance issue along with recommended corrective action. If this tip feature is widely publicized and posted on the same day every month, it could attract large numbers of viewers to the EO web page on a regular basis.

¹⁰ See, “Not-For-Profit Credit Counselors Are Targets Of An IRS Inquiry”, *The New York Times*, October 14, 2003.

4) EO Should Publicize Widely The Availability And Advantages Of Electronic Filing Of Form 990 And Encourage Exempt Organizations To Utilize This Option.

On February 23, 2004, EO debuted its long-awaited Form 990 electronic filing capability.¹¹ To date, 77 organizations have filed their Form 990s electronically and 54 have filed for extensions electronically. EO is to be commended for its willingness to expend the considerable resources that were required to make this innovative project a reality. This project will eventually enable EO to dramatically improve its oversight and monitoring of the exempt sector as well as enable both EO and the organizations that file electronically to realize significant cost savings. For example, as electronic filing of Form 990s becomes more popular, EO will be able to shift resources and personnel currently needed to manually process and store paper returns to substantive enforcement efforts. Electronic filing will also provide more accurate and timely data to both EO and the public. To date, the error rate for electronically filed Form 990s is only 7 percent whereas the error rate for manually filed returns is 53 percent. Further, electronic filing will enable EO to improve its substantive analysis and review of these returns so that it can more readily detect irregularities, inconsistencies, and omissions. Finally, electronic filing will eventually enable EO to improve its case selection criteria to more effectively select for examination organizations where there is a higher likelihood of noncompliance.

For all these reasons, EO should publicize widely the availability of electronic filing and continue to explore incentives to encourage organizations to file electronically. EO recently sent notification to over 500,000 exempt organizations and the IRS will also be sending notification to 66,000 tax professionals about the availability of this new electronic filing option. EO is also working closely with several key state regulatory offices, NASCO, and Independent Sector's Electronic Data Initiative Network (EDIN) to more widely publicize the availability of the new electronic filing option.

As soon as the more widely-used Form 990 preparation software is updated to incorporate electronic filing options, EO should consider making electronic filing mandatory for organizations with assets and/or annual revenue over a certain amount. Finally, as soon as EO implements electronic filing for Form 990 PFs¹², all private foundations should be required to file electronically.

¹¹ As of the date of this report, Form 990, Form 990-EZ, and Form 8868 (Extension of Time to File) can all be filed electronically.

¹² EO anticipates being able to accept electronically filed Form 990PFs early in 2005.

STAFF-RELATED RECOMMENDATIONS: *An essential element of any oversight agency's enforcement and compliance program is its ability to recruit and retain sufficient numbers of well-trained, experienced staff to conduct its oversight responsibilities.*

5) The IRS Should Follow Through With Its Commitment To Hire 72 Additional EO Examination Agents.

Given the dramatic increase in the number of determination requests in recent years and EO's desire to provide good customer service by processing these requests in a more timely manner, it was understandable and appropriate for EO management to reassign many examination personnel to process determination requests. However, it is now critical that the EO examination vacancies created by this decision be filled and that additional positions be added. While it is true that many operational efficiencies can be realized as a result of technological advances, it is unrealistic to expect EO to effectively oversee approximately 90,000 additional exempt organizations each year with the same number of personnel. Over the years, members of many stakeholder groups, including Independent Sector, the Council on Foundations, the ABA Section of Taxation, and NASCO, have consistently urged that additional enforcement resources be provided to EO.

6) EO Should Improve And Enhance Its Current Training And Education Programs For Agents And Examiners.

It is imperative that training provided for EO agents and examiners keep pace with sector developments. Several practitioners related experiences in which they claimed EO agents were inadequately trained to conduct the particular audits to which they were assigned. As a result, these agents allegedly issued burdensome and irrelevant Information Document Requests (IDRs) that required the organizations in question to expend considerable resources complying with these overly-broad and unnecessary requests for information. As with any organization, experienced agents leave or retire on a regular basis and it is critical that EO maintain an ongoing comprehensive education program for its agents and examiners so that they have the appropriate training and skills to conduct their assignments. As a result of budget constraints, EO's ability to offer traditional training opportunities in which agents travel to central locations to receive face-to-face training conducted by EO subject-matter experts has been severely curtailed. In its place, EO has offered on-line training courses and more video conference training. EO should evaluate whether this on-line and video conference training is as effective as face-to-face training and should consider reinstating at least some face-to-face training by EO subject-matter experts as soon as budgetary constraints allow.

PUBLIC EDUCATION RECOMMENDATIONS: *An essential element of any oversight agency's enforcement and compliance program is its ability to regularly*

educate the organizations it oversees so that the organizations can ensure they are in compliance with all applicable laws, rules, and regulations.

7) EO Should Increase Its Issuance Of Technical And Precedential Guidance.

EO practitioners interviewed expressed considerable frustration regarding the significant decrease in the level of technical¹³ and precedential EO guidance issued in recent years. They contend that this seriously hinders their ability to properly advise their exempt clients. It is indisputable that the amount of published guidance issued by EO has decreased significantly in recent years for a variety of reasons. The availability of technical and precedential guidance can greatly increase overall compliance when organizations and their advisors know how EO views certain transactions and practices. EO is to be commended for recently publishing Revenue Rulings 2002-28, 2003-13, and 2004-51 that have each received widespread, and favorable, coverage within the exempt organization community.

Therefore, EO should regularly issue relevant technical and precedential guidance for the exempt organization community and its advisors. Because most organizations will readily conform their conduct to comply with published guidance that clarifies “gray areas” of the law, EO should take full advantage of this cost-effective way to leverage its compliance efforts.

We commend EO for recently posting to the EO web page all past Continuing Professional Education (CPE) Manuals so that this technical guidance is readily available to exempt organizations and their advisors. However, EO needs to follow through with its announced plans to regularly post additional relevant CPE articles on its web page in a more timely manner.

8) EO Should Increase The Number And Technical Content Of Public Presentations And Other Educational Initiatives.

EO leadership and technical staff need to take full advantage of any and all opportunities to interact with and educate members of the exempt organization community and their legal and accounting advisors. Public interaction and speeches by EO leadership and technical staff are, and have historically been, an important way for EO to leverage its limited resources by providing information about EO technical positions, various enforcement and compliance efforts, and areas of concern. By speaking regularly about EO’s technical positions, enforcement efforts, and compliance concerns at national and regional conferences for exempt organizations and their legal and accounting advisors, EO leadership and technical staff help educate the exempt organization community about irregularities and violations EO agents are uncovering

¹³ Technical guidance refers to non-precedential information concerning EO’s views on particular transactions or practices. Such guidance includes private letter rulings, technical advice memoranda, and continuing professional education texts.

during their examinations. When EO leadership and technical staff highlight these areas of concern, EO practitioners routinely advise their exempt organization clients to make sure their organizations are in compliance in those areas. For example, if EO leadership or technical staff indicate at a major national conference that EO either is, or will soon be, taking a look to see whether organizations are correctly reporting “gross contributions” rather than just “net contributions” on Line 1a of their Form 990 returns, most exempt organization representatives will ensure that their organizations are properly completing this line on the Form 990. Thus, as a result of a single comment made by EO leadership or technical staff at a conference, dozens, if not hundreds, of organizations may remedy a significant discrepancy on their Form 990s without a single letter or formal contact having been made by EO. EO needs to take full advantage of this simple, cost-effective way to leverage its resources.

CONSEQUENCE-RELATED RECOMMENDATION: *An essential element of any oversight agency’s enforcement and compliance program is its ability to encourage compliance by regularly documenting and pursuing significant violations of the laws, rules, and regulations the agency is responsible for enforcing.*

9) EO Should Increase The Consequences For Both Individuals And Organizations That Intentionally Submit False Form 990 Returns Or Otherwise Violate The Law.

EO should enhance its review of Form 990 returns so that, at minimum, organizations that file returns containing apparent falsifications, misrepresentations, and/or omissions are routinely required to explain these apparent discrepancies and, if appropriate, file amended Form 990s. As was mentioned earlier, technological advances will enable EO to conduct more substantive review of Form 990s to detect, and follow up on, apparent falsifications, misrepresentations, and/or omissions on these key public documents. As it acquires more comprehensive Form 990 data, EO will enhance its abilities in this area and thereby improve the accuracy of these key documents upon which the donating public, the media, and regulatory oversight agencies must necessarily rely. As was pointed out at the beginning of this report, it is crucial that exempt organizations, their advisors, and the public feel confident that EO routinely reviews Form 990s and follows up on apparent discrepancies.

EO should ensure that individuals and organizations that intentionally file false Form 990s and Form 1023s are prosecuted appropriately. EO needs to ensure that both individuals and organizations that intentionally submit false Form 990 returns and Form 1023 applications are prosecuted appropriately under Sections 7206(1) and (2) of the Internal Revenue Code. Section 7206(1) authorizes the prosecution of any person who willfully makes a false statement in a return or other document submitted to the IRS. Section 7206(2) authorizes the prosecution of any person who “willfully aids or assists in . . . counsels, or advises the preparation . . . of a return . . . which is fraudulent or . . . false as to any material matter.” Since both Form 990s and Form 1023s are

signed under penalty of perjury, those who make intentional material false statements in Form 990s and Form 1023s should be prosecuted for doing so. This will send a clear message to those who prepare and submit these public documents upon which EO, state regulators, and the public must necessarily rely, that those who intentionally falsify these documents will be prosecuted appropriately. To facilitate EO's ability in this regard, it should create a specialized fraud unit, staffed with experienced EO agents and attorneys who have demonstrated their ability to assemble and document complex fraud cases. Implementation of this recommendation will improve the quality and integrity of the Form 990s filed with EO and is especially important given the fact that almost two million Form 990s are now widely available on the Internet through the *GuideStar* website.¹⁴ To the extent that many of these Form 990s contain material falsifications, misrepresentations, and omissions, their value is significantly diminished.

EO should increase criminal referrals when egregious and illegal conduct by exempt organizations and/or their principals is documented. While it is true that much of the wrongdoing by exempt organizations and their officers, directors, and employees does not rise to the criminal level, some of it unequivocally does. Therefore, it is critical that documented allegations of egregious and illegal conduct by exempt organizations and/or their principals be pursued criminally in order to deter others and to increase public confidence in the sector. To maximize the deterrent effect of these cases, all criminal prosecutions of exempt organizations and/or their principals should be highly publicized by EO.

ENFORCEMENT-RELATED RECOMMENDATIONS: *An essential element of any oversight agency's enforcement and compliance program is its ability to encourage voluntary compliance and to coordinate its efforts with state and federal agencies that have similar enforcement responsibilities.*

10) EO Should Implement A Formal Voluntary Compliance Program.

There is considerable anecdotal evidence that many exempt organizations are not in compliance either because they have not filed required Form 990 returns or otherwise. Many of these organizations remain out of compliance mainly because of their concern that if they voluntarily call attention to their noncompliance they will be subjected to prohibitively high fines, penalties, and interest that would literally put them out of business. Knowledgeable EO practitioners have known for years that EO has an "informal" voluntary compliance program where organizations that have been out of compliance for many years can often get back into compliance after agreeing to pay negotiated penalties and interest for only the most recent of their years of noncompliance. However, the existence of this "informal" EO voluntary compliance program is not widely known within the exempt organization community. Given the success of TE/GE's other voluntary compliance programs, EO should consider

¹⁴ As of March 1, 2004, *GuideStar* had approximately 1.7 million IRS 990s available on its website at www.guidestar.org.

implementing its own formal voluntary compliance program so that many more organizations can be given the opportunity to remedy their noncompliance without fear of being subjected to prohibitively high fines, penalties, and interest. Given EO's limited resources, many of these organizations might otherwise never be discovered and brought into compliance.

11) EO Should Vigorously Support Amendment Of Section 6103.

As was noted at the outset of this report, while EO plays a vital role in overseeing and monitoring the exempt sector, it is not the only governmental entity charged with this responsibility. EO shares this responsibility with various state regulatory offices that are also charged with overseeing and monitoring exempt organizations operating in their respective states. However, Section 6103 of the Internal Revenue Code does not permit EO to share information or coordinate its enforcement efforts with these various state regulatory agencies.

Donors, legitimate exempt organizations, the media, and Congress all expect state regulators and EO to pursue aggressively those who defraud donors and siphon millions from the exempt sector each year. Unfortunately, Section 6103 of the Internal Revenue Code significantly hinders EO's and state regulators' abilities to fulfill this expectation because it prohibits EO from sharing information and coordinating its investigations and audits with the various state agencies that have concurrent responsibility to oversee the exempt sector. This prohibition even prevents EO from sharing information with state regulators on cases the states have developed and referred to EO. Consequently, amendment of Section 6103 would significantly increase the effectiveness of both EO and state regulators by allowing them to coordinate their investigative and audit activities where appropriate.

Amendment of Section 6103 has been the number one strategic planning goal of NASCO for many years. Section 6103's amendment has been recommended by both the staff of the Joint Committee on Taxation¹⁵ and the General Accounting Office,¹⁶ and has been incorporated into one of the most recent versions of the CARE Act. As recently as March 21, 2004, U.S. Senate Finance Committee Chairman Charles Grassley reaffirmed his support for amending Section 6103 and indicated his intention to do whatever it takes to get this beneficial amendment passed.¹⁷ For all these reasons, EO needs to vigorously support the proposed amendment of Section 6103.

¹⁵ See, "Volume II: Study of Disclosure Provisions Relating to Tax-Exempt Organizations", Joint Committee on Taxation Staff Report, January 28, 2000, JCS-1-00

¹⁶ "Tax-Exempt Organizations: Improvements Possible in Public, IRS, and State Oversight of Charities", GAO Report to the Chairman and Ranking Minority Member, Committee on Finance, U.S. Senate, GAO-02-526.

¹⁷ See "Questions About Some Charities' Activities Lead To A Push For Tighter Regulation", *The New York Times*, March 21, 2004, where it states that "[i]f Mr. Grassley has his way, federal and state regulators may begin working together more closely to oversee charities. He is trying to find ways to better coordinate the activities of the

VII. CONCLUSION

EO and state regulators serve vital roles in maintaining confidence in the exempt sector by exercising their respective oversight and monitoring responsibilities. EO plays a particularly crucial role since it is the government entity responsible for determining which organizations receive, and retain, exempt status. In this capacity, EO helps assure the donating public that organizations granted exempt status are legitimate and worthy of support. Contributors, exempt organizations, and their professional advisors need to feel confident that EO thoroughly reviews applications for exempt status; routinely reviews exempt organization annual Form 990 returns; investigates questionable returns and organizations; and ensures that those who intentionally falsify these returns or otherwise violate the law are punished appropriately.

By implementing the recommendations outlined in this report, EO will enhance its enforcement and compliance efforts and significantly increase its “presence” in the exempt organization community, even in an environment of fiscal austerity. Implementation of each recommendation will result in a “ripple” effect throughout the exempt organization community as EO’s enhanced enforcement and compliance efforts become more widely known. The reality and perception that EO is more effectively overseeing the sector will function like a single stone tossed into the water increasing awareness throughout the exempt organization community.

attorneys general and the Internal Revenue Service, which oversees tax-exempt organizations at the federal level. Measures that would let the IRS share more information with state regulators are included in pending legislation. “If they don’t get through there, we’ll have other tax bills and we’ll incorporate them in those,” the senator said.”