

# TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



## **Review of the IRS's Enforcement Program for Tax-Exempt Organizations That Participate in Illegal or Nonexempt Activities**

September 29, 2022

Report Number: 2022-10-064

# HIGHLIGHTS: Review of the IRS's Enforcement Program for Tax-Exempt Organizations That Participate in Illegal or Nonexempt Activities

Final Audit Report issued on September 29, 2022

Report Number 2022-10-064

## Why TIGTA Did This Audit

This audit was initiated at the request of the chair of the House Ways and Means Subcommittee on Oversight. The overall objective of this audit was to assess the IRS's ability to identify tax-exempt organizations potentially involved in illegal or nonexempt activities and the processes in place when potential illegal or nonexempt activities are identified.

## Impact on Tax Administration

The IRS's Exempt Organizations and Government Entities function (EO function) is responsible for oversight of tax-exempt organizations. According to the EO function, its mission is to provide 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. If the IRS does not identify potential illegal or fraudulent activities by tax-exempt organizations, unscrupulous individuals could take advantage of this preferred tax status to commit crimes. This could result in diminished public trust in legitimate tax-exempt organizations.

## What TIGTA Found

TIGTA found that both the IRS and State charity regulators are limited by their respective laws and procedures for coordinating with each other as a means to identify tax-exempt organizations potentially engaging in illegal or other nonexempt activities. Currently, no State Attorneys General Offices have formal disclosure agreements with the IRS.

TIGTA identified 3,726 closed EO function referrals alleging potential fraudulent or illegal activities during Fiscal Years 2018 through 2020. For these referrals, classifiers inaccurately recorded the results for 42 cases on the referral database. In addition, for the 15,522 unique referral cases closed during Fiscal Years 2018 through 2020, our analysis identified 980 closed cases for which two referral database fields included conflicting information about the final dispositions of the referrals. TIGTA also determined that 2,934 data fields were missing required information because referral database system controls do not require these fields to be completed prior to the case closing.

TIGTA reviewed two judgmental samples consisting of 46 referral cases closed between Fiscal Years 2018 and 2020 that alleged potentially fraudulent or illegal activities to determine whether the IRS's assessments of the referrals were sufficiently researched and properly documented. All 46 referral cases sampled were sufficiently researched. However, five of the 46 referrals did not have sufficient documentation to justify the decision to not pursue an examination.

Finally, during this review and as in prior reviews, TIGTA found that the IRS has processes in place to identify whether a tax-exempt organization engages in substantial activities that do not further their tax-exempt purpose.

## What TIGTA Recommended

TIGTA recommended that the IRS should: 1) ensure that Classification managers periodically emphasize to classifiers the importance of including supporting documentation in the case files for selecting or not selecting referrals for examination; 2) implement referral database system controls to ensure that complete and accurate data is input into the database; and 3) review the fields on the referral database and determine if any may be eliminated to avoid confusion, conflicting information in similar fields, and redundancy.

The IRS agreed with our recommendations and plans to take corrective actions.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

**U.S. DEPARTMENT OF THE TREASURY**

**WASHINGTON, D.C. 20024**

September 29, 2022

**MEMORANDUM FOR:** COMMISSIONER OF INTERNAL REVENUE

**FROM:**

*Heather Hill*

Heather M. Hill  
Deputy Inspector General for Audit

**SUBJECT:**

Final Audit Report – Review of the IRS’s Enforcement Program for Tax-Exempt Organizations That Participate in Illegal or Nonexempt Activities (Audit # 202110025)

This report presents the results of our review to assess the Internal Revenue Service’s ability to identify tax-exempt organizations potentially involved in illegal or nonexempt activities and the processes in place when potential illegal or nonexempt activities are identified. This review was requested by Representative Bill Pascrell, Chairman of the House Ways and Means Subcommittee on Oversight, and is part of our Fiscal Year 2022 Annual Audit Plan addressing the major management and performance challenge of *Improving Tax Reporting and Payment Compliance to Reduce the Tax Gap*.

Management’s complete response to the draft report is included as Appendix IV.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Bryce Kisler, Acting Assistant Inspector General for Audit (Management Services and Exempt Organizations).

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## **Background**

The benefits of having tax-exempt status include exemption from Federal income tax and, in some instances, eligibility to receive tax-deductible charitable contributions. An organization must be organized and operated in a way that meets the requirements of the subsection under which it is recognized or claims exempt status. The requirements vary depending on which subsection is applicable (*e.g.*, Internal Revenue Code (I.R.C.) § 501(c)(3) charities; I.R.C. § 501(c)(4) social welfare organizations) and require the application of the relevant law to the facts and circumstances of the particular organization applying for tax exemption or being examined.

The Internal Revenue Service's (IRS) Exempt Organizations (EO)/Government Entities function (hereafter referred to as the EO function) is responsible for oversight of tax-exempt organizations. According to the EO function, its mission is to provide 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. If the IRS does not identify potential illegal or fraudulent activities by tax-exempt organizations, unscrupulous individuals could take advantage of this preferred tax status to commit crimes. This could result in diminished public trust in legitimate tax-exempt organizations.

## **Explanation of Illegal and Nonexempt Activities**

### **Illegal Activities – General**

Exempt purposes may generally be equated with the public good, and violations of law are the opposite of the public good, so the nature and extent of any illegal activities engaged in by organizations affect their qualification for tax-exempt status.<sup>1</sup> In addition, tax exemption for charitable organizations is often justified on the grounds that charitable organizations lessen the burdens of government by providing benefits to the public that would otherwise have to be furnished by the government. Organizations engaged in illegal activity increase the governmental burden of law enforcement.<sup>2</sup> Moreover, if an organization is identified or designated as a terrorist organization within the meaning of I.R.C. § 501(p)(2), its tax-exempt status and its eligibility to apply for recognition of exemption are automatically suspended. The IRS may not be in a position to make determinations as to the illegality of an act under a provision of law other than the I.R.C.

### **Illegal Activities – Fraud**

According to the Internal Revenue Manual, fraud is the deception by misrepresentation of material facts, or silence when good faith requires expression, which results in material damage to the one who relies on it and has the right to rely on it.<sup>3</sup> Tax fraud is often defined as an intentional wrongdoing, on the part of a taxpayer, with the specific purpose of evading a tax

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<sup>1</sup> IRS, EO Continuing Professional Education, *Topic J. Activities That Are Illegal or Contrary to Public Policy*, p. 1 (1985).

<sup>2</sup> IRS, EO Continuing Professional Education, *Topic L. Illegality and Public Policy Considerations*, p. 2 (1994).

<sup>3</sup> Internal Revenue Manual 25.1.1.3 (Jan. 23, 2014).

known or believed to be owing. Tax fraud requires both: 1) tax due and owing and 2) fraudulent intent.

### **Illegal Activities – Acts by individuals within an organization**

Actions by members and officers of an organization do not always reflect on the organization. Because organizations act through individuals, it is necessary to distinguish those activities of individuals that are done in an official capacity from those that are not. Activities that should be considered “of the organization” include only: 1) acts by an organization’s officials pursuant to actual or purported authority to act for the organization; 2) acts by agents of the organization within their authority to act; or 3) acts ratified by the organization.<sup>4</sup>

**Acts by members of a  
tax-exempt organization are  
not necessarily carried out on  
behalf of the organization.**

### **Nonexempt Activities**

Activities that do not further an organization’s tax-exempt purpose are considered nonexempt but not necessarily illegal. For instance, unrelated business income is income from a trade or business, regularly carried on, that is not substantially related to the charitable, educational, or other purpose that is the basis of the organization’s exemption.

## **Key IRS Divisions and Functions**

### **Tax Exempt and Government Entities Division**

The Tax Exempt and Government Entities (TE/GE) Division has important responsibilities for both the oversight of regulatory compliance as well as compliance with tax requirements pertaining to tax-exempt organizations and other organizations and entities such as pension plans and government entities. It oversees approximately 1.9 million tax-exempt entities with varying requirements for tax-exempt status.<sup>5</sup> Within the TE/GE Division, the EO and the Compliance Planning and Classification (CP&C) functions play a role in the identification, prevention, and enforcement of tax compliance for tax-exempt organizations potentially involved in illegal or nonexempt activities.

### **Criminal Investigation**

Criminal Investigation (CI) investigates potential criminal violations of the I.R.C. and related financial crimes. In many instances, proving that a taxpayer willfully attempted to hide income from the Federal Government is an integral part of proving other criminal activity, including fraud and money laundering. The findings of these investigations are referred to the Department of Justice for recommended prosecution.

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<sup>4</sup> IRS, EO Continuing Professional Education, *Topic J. Activities That Are Illegal or Contrary to Public Policy*, p. 2 (1985).

<sup>5</sup> Publication 55-B, *Internal Revenue Service Data Book, 2020*, Table 14: Tax-Exempt Organizations, Nonexempt Charitable Trusts, Nonexempt Split-Interest Trusts, Fiscal Year 2020, p. 30 (June 2021).

## **Results of Review**

Overall, the IRS has processes in place to receive information from third parties, such as State law enforcement, on tax-exempt organizations potentially involved in illegal or nonexempt activities. However, due to the complexities of the law, there is limited collaboration with third parties to actively identify noncompliance. In addition, the IRS function responsible for deciding the examination potential of referrals determined that few alleging illegal or fraudulent activity by tax-exempt organizations warrant examinations. Further, information entered into the IRS's referral database is not always accurate or complete. Finally, during this review and as in prior reviews, the Treasury Inspector General for Tax Administration (TIGTA) found that the IRS has processes in place to identify whether a tax-exempt organization engages in substantial activities that do not further its tax-exempt purpose.

### **Coordination Efforts With States to Identify Illegal Activities or Other Noncompliance Are Limited**

Both the IRS and State charity regulators are limited by their respective laws and procedures for coordinating with each other as a means to identify tax-exempt organizations potentially engaging in illegal or other nonexempt activities.

#### **The IRS and State charity regulators share limited information on potentially noncompliant tax-exempt organizations**

We interviewed a judgmental sample of five State charity regulators from California, Massachusetts, New York, Oregon, and Texas to understand their role in identifying potential illegal activities of tax-exempt organizations and the degree of collaboration with the IRS.<sup>6</sup>

State Attorneys General (AG) Offices may enter into formal disclosure agreements with the IRS to receive returns and return information from the IRS under I.R.C. § 6104(c). However, the Pension Protection Act of 2006 amended the law to both expand the scope of the disclosure and require recipients of taxpayer information, such as State AG Offices, to meet comprehensive technical, procedural, and administrative Federal safeguard requirements per I.R.C. § 6103(p)(4).<sup>7</sup> According to some State AG Office officials we interviewed, these requirements are burdensome to implement and may increase resource use for the States to maintain.<sup>8</sup> Because of these obstacles, a majority of the State AG Office officials that we spoke with are reluctant to enter into formal disclosure agreements with the EO function. Currently, no State AG Offices have formal disclosure agreements with the IRS; however, the IRS has nine formal disclosure agreements with State tax offices.

State AG Offices can refer to the IRS tax-exempt organizations engaged in activities that potentially violate Federal tax law. However, several of the State charity regulators we

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<sup>6</sup> A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population.

<sup>7</sup> Pub. L. No. 109-280, 120 Stat. 780.

<sup>8</sup> The IRS shares tax-exempt information returns with States under the EO Fed/State Program and routinely accepts referrals from external sources, including State agencies, alleging noncompliance with Federal tax laws by tax-exempt organizations. The IRS also provides the Tax-Exempt Organization Search Tool on its website for users to find information on an organization's status and filings.

interviewed indicated that they receive little to no feedback for referrals submitted to the IRS. All submitters of referrals receive an acknowledgement letter explaining that minimal feedback is due to statutory restrictions within the existing referral process that prevents updates or feedback to external stakeholders, such as State AG Offices. The letter explains that I.R.C. § 6103 requires that tax returns and return information must be confidential, and disclosure cannot be made except as authorized by the I.R.C. Therefore, the IRS cannot disclose whether it has initiated an investigation based on the information submitted in a referral and cannot disclose the status of any investigation.

### **Individual States have differing laws for State initiated dissolutions of nonprofit entities**

To apply for recognition of exemption, an entity must be organized as a corporation, a limited liability company, an unincorporated association, or a trust. State law generally determines whether an organization is properly created and establishes the requirements for organizing documents. Once established, these organizations must comply with their State laws or risk State-initiated dissolution.

TIGTA concluded that the State-initiated dissolution of an organization by the State in which it is organized or incorporated is a material change in facts as described in Revenue Procedure 2022-5.<sup>9</sup> As a result, the organization can no longer rely on an IRS determination letter recognizing it as exempt from Federal taxation. Each State has its own requirements for dissolving a nonprofit organization, with some allowing organizations to correct the noncompliance up to five years after dissolution and have their nonprofit status reinstated. This variation among the States makes it difficult for the IRS to use State dissolution data as a tool to ensure that its taxpayer account data are accurate.

A tax-exempt organization established in one State can conduct operations (*e.g.*, solicit contributions or rent property) or move its operations to another State. If it moves to another State, the tax-exempt organization must notify the IRS that it has changed its business mailing address, its business location, or the identity of the responsible party.<sup>10</sup> According to Revenue Procedure 2018-15, the IRS generally will not require an organization to reapply for tax-exempt status if it reorganizes or moves to another location.<sup>11</sup> However, for organizations that reincorporate in another State, it must be in good standing with the State in which it was originally incorporated in order to rely on its current tax-exempt determination. Therefore, organizations that previously had been dissolved by the State in which they were originally organized or incorporated would need to reapply with the IRS for tax-exempt status in the new State.

### **Analysis of dissolved organizations**

The National Association of State Charity Officials (NASCO) is an association of State offices (attorneys general, secretaries of state, and other offices) charged with the regulation and oversight of charitable organizations and charitable solicitation in the United States. Each year,

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<sup>9</sup> Rev. Proc. 2022-5, 256–296 I.R.B. 2022-1 (Jan. 3, 2022).

<sup>10</sup> A tax-exempt organization must report its name, address, and structural and operational changes to the IRS. If an organization files an annual return (such as a Form 990, *Return of Organization Exempt From Income Tax*, or a Form 990-EZ, *Short Form Return of Organization Exempt From Income Tax*), it must report the changes on its return.

<sup>11</sup> Rev. Proc. 2018-15, 379–383 I.R.B. 2018-9 (Feb. 26, 2018).

NASCO representatives compile and release their *Annual Report on State Regulation and Enforcement*. The report provides a representative sample of cases and other initiatives in the areas of deceptive solicitation, governance and breach of fiduciary duties, trust and estate issues, and healthcare issues as well as other issues, including registration, legislation, and guidance.

TIGTA analyzed the NASCO's Calendar Years 2019 and 2020 annual reports and the Federal Trade Commission's *Operation Donate with Honor: List of Enforcement Actions* (July 19, 2018) to identify State actions taken against nonprofit organizations.<sup>12</sup> Of the 155 organizations identified in these reports, 35 (23 percent) organizations ended operations or were dissolved by the State in which they were organized or incorporated. Of these 35 nonoperating organizations, six (17 percent) were still listed on the IRS's Publication 78, *Cumulative List of Organizations*, at the time of our review in October and November 2021.<sup>13</sup>

We also compared Publication 78 data with a judgmental sample of 34 of the 212 dissolutions listed on the website of the New York State AG Office during Fiscal Years (FY) 2018 through 2020 and determined that 11 of the tax-exempt organizations were still listed by the IRS as active I.R.C. § 501(c)(3) organizations as of November 2021.<sup>14</sup>

I.R.C. § 6043(b) and Treasury regulations establish rules for when a tax-exempt organization must notify the IRS that it has undergone a liquidation, dissolution, termination, or substantial contraction.<sup>15</sup> Generally, most organizations must notify the IRS when they terminate. Among other things, notice to the IRS of a termination will close the organization's account in IRS records. An organization required to file an annual return or notice should indicate its termination on its final annual return or notice.

The complexity and varying State-initiated dissolution laws make it difficult for the IRS to use State-initiated dissolution data to update taxpayers' accounts. Our analysis, discussed below, showed that the IRS is limited to relying on the organizations to provide final termination information so that it can timely update taxpayers' accounts.

### **The IRS relies on systemic automatic revocation if organizations stop filing returns**

Automatic revocation occurs when a tax-exempt organization that is required to file an annual return or submit an annual electronic notice does not do so for three consecutive years.<sup>16</sup> Under the law, the organization's Federal tax-exempt status is automatically revoked.

From our two judgmental samples of NASCO/Federal Trade Commission and New York State AG Office dissolved not-for-profit corporations that have recognized Federal tax-exempt status,

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<sup>12</sup> The 2019 NASCO report referenced the Federal Trade Commission's *Operation Donate with Honor: List of Enforcement Actions* (July 19, 2018).

<sup>13</sup> Publication 78 lists IRS-approved I.R.C. § 501(c)(3) tax-exempt organizations and is used by taxpayers to identify qualified charities.

<sup>14</sup> Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.

<sup>15</sup> Treas. Reg. § 1.6043-3 (as amended in 2007).

<sup>16</sup> The Form 990 series of returns includes the Form 990; Form 990-EZ; Form 990-PF, *Return of Private Foundation or Section 4947(a)(1) Trust Treated as Private Foundation*; and Form 990-N, *Electronic Notice (e-Postcard) for Tax Exempt Organizations Not Required to File Form 990 or Form 990-EZ*. Not all types of tax-exempt organizations are required to file annual information returns or to submit Form 990-N; for example, churches have no such filing requirements.

we identified five organizations that filed at least one return after dissolution but did not indicate that it was their final return. As a result, their IRS accounts remain active, and the organizations will likely continue to be listed on Publication 78 longer than the three-year period. After three consecutive years of not filing a return, they will automatically lose their tax-exempt status. The IRS sends a notice to each organization, at its last known address, stating that its exempt status has been automatically revoked because it has not filed a required annual return or notice for three consecutive years.

### **The EO function has actively engaged with State charity regulators to conduct outreach and educational activities**

The EO function performs customer outreach with external stakeholders to educate them on the IRS's efforts to identify noncompliance. For instance, during FYs 2019 and 2020, the EO function participated in quarterly meetings with the NASCO to discuss emerging issues, educate stakeholders on publicly available abusive transaction schemes in the tax-exempt sector, and answer questions from State regulators.

### **CI coordination with States and other regulators**

CI does not establish formal disclosure agreements with State Governments or other Federal law enforcement agencies. However, CI shares information with other agencies while working grand jury investigations and participates on task forces such as the Joint Terrorism Task Force.<sup>17</sup> The Joint Terrorism Task Force did not receive any referrals for tax-exempt organizations for FYs 2018 through 2020.

CI management indicated that CI has not engaged in any outreach or educational activities during FYs 2018 through 2020. However, there have not been any specific inquiries by any outside law enforcement agencies for CI to conduct such training on identifying potential illegal activity by tax-exempt organizations.

During FYs 2018 through 2020, CI received 10 referrals from external sources (Federal, State, and local law enforcement) that pertained specifically to tax-exempt organizations. Nine of these referrals were closed after preliminary investigations for reasons such as being related to another investigation or lacking sufficient evidence or witnesses. The remaining referral remained open as of January 2022.<sup>18</sup>

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<sup>17</sup> The Joint Terrorism Task Force's mission is to enhance communication, coordination, and cooperation between Federal, State, and local government agencies by providing a central point for the sharing of terrorism threats and intelligence.

<sup>18</sup> CI does not track cases specific to tax-exempt organizations but rather used key terms (*e.g.*, "exempt entity," "exempt organization," "charity") to identify investigations involving tax-exempt organizations on its Criminal Investigation Management Information System database.

## **The Compliance Planning and Classification Function Determined That Few Referrals Alleging Illegal or Fraudulent Activity by Tax-Exempt Organizations Warrant an Examination**

The CP&C function has the responsibility to develop, plan, and deliver a workplan to address the TE/GE Division's greatest compliance risks. The CP&C function's Classification and Case Assignment unit classifies returns, referrals, and claims to determine if they warrant examination or compliance checks.<sup>19</sup>

The TE/GE Division uses the Reporting Compliance Case Management System (hereafter referred to as the referral database) to track referrals received and processed.<sup>20</sup> However, it does not track referrals based on potential illegal or fraudulent activity. Therefore, to identify applicable referrals, we searched the "Allegation" field on the referral database for terms such as "illegal" and "fraud" to identify referrals alleging this type of activity in cases closed during FYs 2018 through 2020. We also queried the referral database for certain Uniform Issue List codes that may indicate a referral involving alleged illegal or fraudulent activity.<sup>21</sup> Of the 13,329 classified referrals during our review period, we identified 3,726 (28 percent) that alleged potentially fraudulent or illegal activities; however, none of these referrals resulted in an examination.<sup>22</sup>

### **Analysis of referrals alleging potential fraud or illegal activities**

According to Classification and Case Assignment unit procedures, classifiers triage incoming referrals by reviewing the information provided and conducting limited research to determine how to process them. Per the procedures, classifiers should consider all issues identified during classification, including the identification of nonfiled returns, and not rely exclusively on the allegations made when determining which referrals to recommend for an examination. Classifiers should use the tools and information sources available to them to classify all referrals, including the IRS's taxpayer account database, available tax return information, the organization's website, and print media. Figure 1 summarizes the referral classification process.

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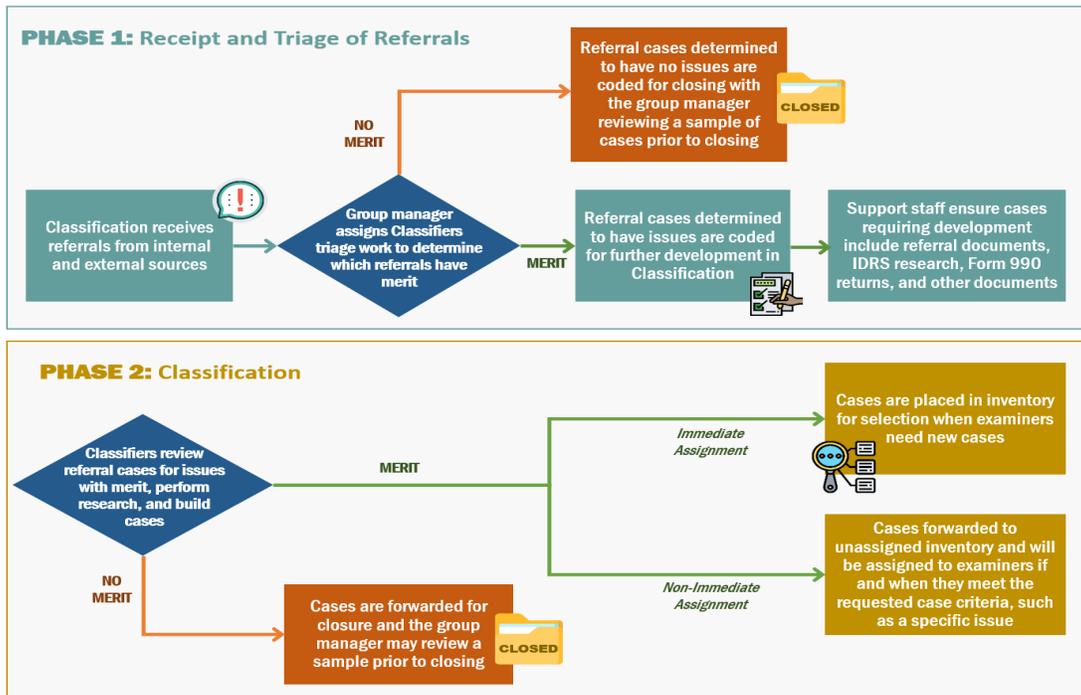
<sup>19</sup> A referral is any communication from the public or a Federal or State regulatory agency about potential noncompliance by a tax-exempt organization. A claim is a request for a refund or a request for an adjustment of tax paid or credit not previously reported or allowed. The IRS uses non-examination reviews called compliance checks to determine whether specific items have been reported properly. Like examinations, compliance checks are an accountability tool but are simpler, less burdensome, and limited in scope. A compliance check is not an examination as it does not directly relate to determining a tax liability for any particular period.

<sup>20</sup> The referral database is used by examiners to create and control examination cases.

<sup>21</sup> The Uniform Issue List is a list of codes used to track examination issues (*e.g.*, "Terrorism Related," "Fraud," "Organized Crime") for various reports.

<sup>22</sup> We conducted our analysis on all unique EO function referrals closed during FYs 2018 through 2020 based on the unique referral case control numbers. We excluded misrouted records (referrals not related to the TE/GE Division) and records designated as Closed Duplicates or Closed Multiples. The two latter designations relate to the subsequent receipt of additional referrals alleging improprieties against the same organization.

Figure 1: Summary Flowchart of the Referral Classification Process



Source: Classification Desk Guide. Note: IDRS = Integrated Data Retrieval System.<sup>23</sup>

Of the 3,726 closed EO function referrals that alleged potentially fraudulent or illegal activities, classifiers closed 1,651 (44 percent) after initial triaging determined there were no tax issues. Classifiers forwarded the remainder of the applicable referrals (56 percent) for further research and development by a second classifier, who determined whether an examination was warranted.

We reviewed available data for the 3,726 closed EO function referrals and identified four common reasons why classifiers concluded that the allegations of illegal activities or fraud did not merit examinations of the tax-exempt organizations. The most common reason was *insufficient corroborating evidence*. Other reasons for not recommending examinations included:

- The allegations did not pertain to tax-exempt organizations.
- There was insufficient time remaining on the tax statute or the statute had expired.<sup>24</sup>
- The allegations were de minimis (minor/insignificant).

**Referrals are most often closed without an examination due to insufficient corroborating evidence.**

### Analysis of sampled referral cases alleging fraud or illegal activities

Classifiers do not always sufficiently document the reasons for not selecting for examination a referral alleging potentially fraudulent or illegal activities. We reviewed two judgmental samples

<sup>23</sup> The Integrated Data Retrieval System is an IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

<sup>24</sup> The IRS is limited by statute for how long it has to examine a return. Cases closed due to the statute expiration date are closed without review.

## Review of the IRS's Enforcement Program for Tax-Exempt Organizations That Participate in Illegal or Nonexempt Activities

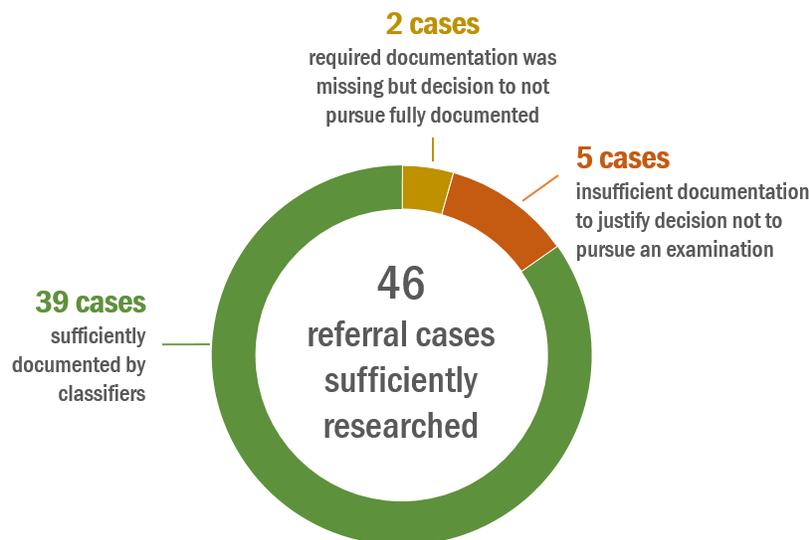
totaling 46 referral cases closed between FYs 2018 and 2020 that alleged potentially fraudulent or illegal activities to determine whether the IRS's assessment of the referrals was sufficiently researched and properly documented.

- One sample included all 16 closed referral cases received from State AG Offices or other State law enforcement offices. We judgmentally chose this population of referrals because they are more likely to include corroborating documentation for the allegations than referrals from the general public, who may not have access to supporting documentation.
- The second sample included 30 judgmentally selected cases from our review of the referral database's "Action Taken" field to determine common reasons classifiers did not recommend referrals for an examination.

For 32 of the 46 referrals reviewed, classifiers did not recommend an examination because they determined that there was insufficient corroborating evidence showing that the tax-exempt organizations used funds for anything other than a charitable purpose. The remaining referrals were not recommended for other reasons, such as that the organization's tax-exempt status was already terminated or revoked by the IRS, the organization was previously examined based on a prior referral, the potential noncompliance amount was de minimis, there was insufficient time remaining on the tax statute or the statute had already expired, or the allegations did not fall under the IRS's oversight responsibilities.

We determined that all 46 referral cases sampled were sufficiently researched. However, seven referral cases were missing documentation: five cases did not have sufficient documentation to justify the decision not to pursue an examination, and two cases were missing required documentation, but the decision to not pursue an examination was fully documented. Classifiers sufficiently documented the remaining 39 case decisions. Figure 2 shows the results of our review of the 46 referral cases.

**Figure 2: Referral Research and Documentation Case Review Results**



Source: TIGTA case analyses.

Per Classification and Case Assignment unit procedures, classifiers should provide a narrative in the case files explaining why each referral is either recommended or not recommended for an examination or why the referral needs further development. In addition, classifiers should include in the case file documentation any research conducted to support the recommendation.

Classification management indicated that current procedures for documenting referral research are more general guidance than requirements. There are no set criteria for what has to be in the case file, and it depends on the circumstances of each case. Classifiers add research results or documents that are needed to support the case decisions. In addition, Classification management explained that their goal is to be as efficient as possible with limited resources for developing the best cases, so classifiers may close some cases with little or no additional research. In addition, classifiers do not add documents to the case file for every research tool that they use, especially when it yields no evidence. For example, according to Classification management, classifiers usually do not include Accurint or Internet research in the case file unless it supports the decision and adds value, including too much information is counterproductive and not efficient.<sup>25</sup>

However, Classification management agreed that there was missing documentation for some of the cases we reviewed, and they indicated that new procedures were implemented in May 2019 to improve documentation. These procedures require support staff to include, in all cases selected for examination, additional documentation such as tax returns, referral documents, and the IRS's taxpayer account database research when establishing them on the referral database. However, support staff do not perform this additional research and include documents in the case file if the classifier forwards the case for closing without recommending an examination, so it is important that classifiers completely document their decisions. In addition, Classification management reviews all "immediate assignment" cases selected for examination as well as approximately 10 percent of the referral cases not selected for examination prior to their closing. This review includes verifying that the classifier accurately entered the information into the referral database.<sup>26</sup>

In a prior report, TIGTA recommended that the IRS should ensure that classifiers document in referral case files the actions taken, research performed, and reasons for decisions on whether or not to forward referrals for examination consideration.<sup>27</sup> The IRS subsequently updated its Classification procedures, requiring classifiers to provide a narrative in the case folder explaining in 25 words or less why they are not recommending a referral for examination or why they are forwarding it for further research and development. In addition, classifiers are to include, among other things, any other pertinent documents in the case folder.

When case files exclude supporting documentation, Classification management does not have assurance that classifiers made appropriate decisions and recommended all referrals with a high risk of noncompliance for examination.

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<sup>25</sup> Accurint is a web-based research tool for public records and asset locator services.

<sup>26</sup> "Immediate assignment" cases are referrals that need to be assigned to the field as soon as possible and include referrals with a strong indicator of fraud or illegal/illicit transactions (including terrorism).

<sup>27</sup> TIGTA, Report No. 2019-10-011, *Review of Processes to Identify and Assist in Investigations of Tax-Exempt Organizations With Potential Links to Terrorism* (Feb. 2019).

**Recommendation 1:** The Director, CP&C, should ensure that Classification managers periodically emphasize to classifiers the importance of including supporting documentation in case files for selecting or not selecting referrals for examination.

**Management's Response:** The IRS agreed with this recommendation and will ensure that Classification managers periodically emphasize to classifiers the importance of including supporting documentation in case files for selecting or not selecting referrals for examination.

### **Information on the Referral Database Is Not Always Accurate or Complete**

When classifiers complete their reviews of referrals, they update the case files on the referral database with their results by selecting various codes on the system. However, classifiers sometimes record inaccurate or incomplete information on the referral database when closing the cases, which may lead to lost opportunities for examining potentially noncompliant tax-exempt organizations. In addition, some fields on the referral database may be redundant or no longer useful.

The Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government* sets the standards for an effective internal control system for Federal agencies and provides the overall framework for designing, implementing, and operating an effective internal control system.<sup>28</sup> Per the Standards, information systems should have controls in place to ensure proper input of data. In addition, ongoing monitoring of information systems should be built into management's oversight procedures to ensure that internal controls continue to be effective.

We determined that system controls of the referral database do not ensure proper input of case review results, resulting in incomplete or inaccurate information. According to Classification and Case Assignment unit procedures, the "Allegation" and "Determination Description" fields are required to be completed for all referrals established on the referral database. However, the referral database system controls do not require these fields to be completed prior to case closure.

According to Classification management, most referrals selected for examination are held in unassigned inventory until examiners request additional cases, so significant time may pass before resources are available to examine the selected cases. It is common for inventoried cases to be reclassified before assignment to ensure that there is still sufficient examination potential and time on the statute. A management official indicated that, at times, employees do not ensure that the referral database information is updated to accurately reflect the final dispositions of the referrals after this reclassification. During the life of a referral, some referral database fields may need to be updated multiple times. In addition, Classification management stated that verifying the accuracy of the referral database information is part of the managerial review process.

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<sup>28</sup> GAO, GAO-14-704G, *Standards for Internal Control in the Federal Government* (Sept. 2014).

## Inaccurate and incomplete entries

Analysis of the 3,726 referrals alleging potentially fraudulent or illegal activities identified 42 referrals that classifiers coded on the referral database as recommended for an examination or compliance check but were never forwarded to the EO function's Examinations unit. However, Classification management confirmed that the referral database included inaccurate coding entries for the final dispositions of these referrals.<sup>29</sup> Classifiers only meant to forward for examination five of the 42 referrals.

- 27 referrals were recommended for examination. However, 23 of these 27 cases were incorrectly coded by the classifier and were not actually intended for an examination. For the remaining four referrals, the classifiers intended to recommend them for examination but selected the incorrect code on the referral database and forwarded them for closing instead of unassigned inventory. Although the miscoding resulted in these cases not being further evaluated for examination, there is no assurance they would have been examined had the error not occurred. Many cases that move from classification to the examination inventory are never examined due to resource limitations, for example, which may cause the statutes of some unassigned inventory cases to expire before assignment.
- 15 referrals were incorrectly recommended for compliance checks on the referral database. Instead, classifiers should have coded 14 of the 15 cases as not selected for examination. The final case was intended for examination, but the classifier incorrectly coded it as a recommended compliance check and then forwarded the case for closing in error.



In addition, from the 15,522 unique referral cases closed during FYs 2018 through 2020,<sup>30</sup> our analysis identified 980 closed cases for which the referral database "Determination Description" and "Final Action Code Description" fields included conflicting information about the dispositions of the referrals.<sup>31</sup> Classification management stated that an entry is not required for the "Final Action Code Description" field, and the field is often left blank because it is considered redundant. Rather, the information is captured in the referral database "Determination Description" field and the case notes. However, out of the 15,522 unique referral cases, 15,372 had completed "Final Action Code Description" fields, which presents a risk that management could rely on potentially inaccurate or misleading information because some classifiers leave the field blank.

We also determined that case referral data within the referral database are not always complete. For example, our analysis determined that the "Allegation" and "Determination Description"

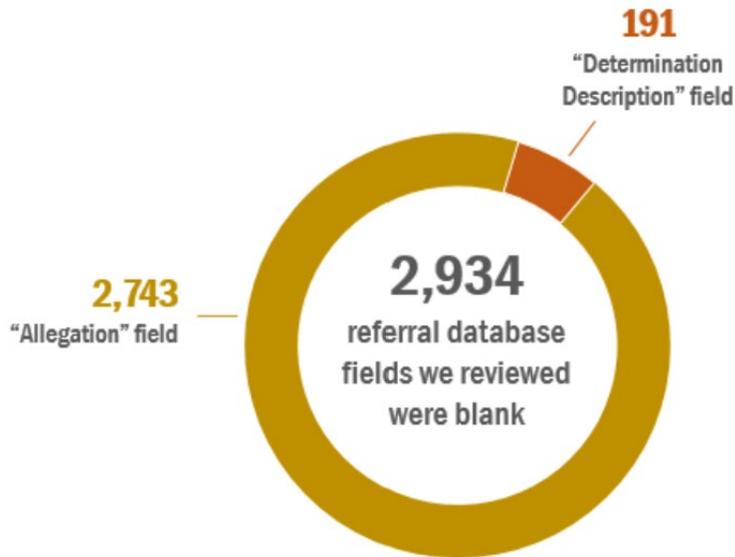
<sup>29</sup> See Appendix II for additional details.

<sup>30</sup> We conducted our analysis on all unique EO function referral cases closed during FYs 2018 through 2020, based on unique referral case control numbers, regardless of how they were closed. The universe included cases closed as misrouted records (referrals not related to the TE/GE Division) and records designated as Closed Duplicates or Closed Multiples.

<sup>31</sup> See Appendix II for additional details.

fields were not always completed on the referral database. We identified 2,934 required referral database fields that were blank, comprised of 2,743 "Allegation" fields and 191 "Determination Description" fields.<sup>32</sup> Figure 3 summarizes the results of the analysis.

**Figure 3: Number of Incomplete Referral Database Fields**



Source: TIGTA Referral Database Analysis.

Because the referral database information was not always accurate or complete, the reliability of the data is questionable. In addition, we do not have assurance that we identified all EO function referrals alleging fraudulent or illegal activities during our review period of FYs 2018 through 2020 because the "Allegation" field was sometimes blank, thus our analysis of the data may be incomplete.

According to the GAO's *Standards for Internal Control in the Federal Government*, quality of information means, among other things, that the information is accurate and complete. Quality information allows management to make informed decisions and evaluate their entity's performance in achieving key objectives and addressing risks. If case results are not properly entered into the required fields of the referral database, then management cannot rely on it as an accurate and complete administrative record of work to use for retrospective reviews of past casework, improving the efficiency of case processing, or performing managerial reviews of current casework.

The Director, CP&C, should:

**Recommendation 2:** Determine the feasibility of making changes to referral database system controls to ensure that required fields are completed and accurate data are input when classifiers update/close cases.

**Management's Response:** The IRS agreed with this recommendation and will determine the feasibility of making changes to referral database system controls to

<sup>32</sup> See Appendix II for additional details.

ensure that required fields are completed and accurate data are input when classifiers update/close cases.

**Recommendation 3:** Review the fields on the referral database and determine if any may be eliminated to avoid confusion, conflicting information in similar fields, and redundancy.

**Management's Response:** The IRS agreed with this recommendation and will review the fields on the referral database and determine if any may be eliminated.

## **Processes Are in Place to Identify Whether a Tax-Exempt Organization Engages in Substantial Activities That Do Not Further Its Tax-Exempt Purpose**

The TE/GE Division provides guidance and training to its employees for identifying tax-exempt organizations that engage in substantial activities that do not further their tax-exempt purpose. We reviewed recent TIGTA and GAO audit reports as well as current policies, procedures, and training materials to identify prior audit work in the area and the IRS's processes and procedures followed.<sup>33</sup> Several units within the EO and CP&C functions play a role in identifying tax-exempt organizations' activities that are for nonexempt purposes, such as reviewing organizations' applications for tax-exempt status, reviewing referrals, and researching, identifying, and examining tax-exempt organizations' tax compliance.

### **The EO function's Rulings and Agreements unit**

The EO function's Rulings and Agreements unit is responsible for issuing determination letters on exempt status, private foundation classification, and other determinations related to tax-exempt organizations. Rulings and Agreements unit employees prepare an examination referral and send the case file to the CP&C function when an organization: 1) likely has past taxes or penalties due or 2) has potential future activities that may jeopardize its tax-exempt status.

We determined that the Determinations unit employees, within the EO function's Rulings and Agreements unit, have sufficient procedures and processes to identify determination letter requests that may include activities substantially different than an organization's proposed tax-exempt purposes as well as fraud and illegal activities, such as financing terrorism. Managers review determination decisions to ensure that employees follow procedures to reach an appropriate conclusion about eligibility for tax-exempt status. A Quality Assurance group reviews a sample of determination cases to ensure technical and procedural accuracy as well as identifies areas needing improvement. We are currently performing a separate audit to assess the quality review process for making tax-exempt determinations.<sup>34</sup>

In addition, the TE/GE Division has provided comprehensive determination training as well as numerous, periodic fraud identification and development training sessions, which provide employees with the information and resources needed to properly evaluate determination letter requests. Processes are also in place to refer determination letter applications for further review

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<sup>33</sup> See Appendix III for additional details.

<sup>34</sup> TIGTA, 2022 Annual Audit Plan, Audit # 202210029, *Quality Review Processes for § 501(c)(3) Applications for Tax-Exempt Status*.

by the EO function's Examinations unit or CI if there are firm indications of civil or criminal fraud, respectively.<sup>35</sup> The Determinations unit referred two determination letter requests during FYs 2018 through 2020 for potential criminal investigation. CI returned them without pursuing charges, and both organizations were subsequently granted tax-exempt status.

However, TIGTA recently reported that one of the available applications used to request tax-exempt status, Form 1023-EZ, *Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, does not provide the IRS with sufficient information to appropriately approve or deny an organization's tax-exempt status.<sup>36</sup> As a result, the IRS is approving organizations for tax-exempt status that may not qualify. For example, in May 2022, the Brooklyn District Attorney's Office indicted a man on charges of grand larceny, identity theft, and conducting a scheme to defraud by allegedly forming 23 fraudulent charitable entities and collecting at least \$152,000 in donations. Per our data analysis, the IRS approved 56 Forms 1023-EZ applications submitted by this individual in FYs 2019 and 2020, all with the same address. In addition, the Taxpayer Advocate Service completed four studies between Calendar Years 2015 and 2019 of organizations for which the IRS approved their Form 1023-EZ applications and found that, between 26 and 46 percent of the time, the approved organizations did not meet the organizational test and did not qualify for tax-exempt status.

## **The CP&C function**

The CP&C function is comprised of three units: Issue Identification and Special Review, Classification and Case Assignment, and Planning and Monitoring. The first two units are directly involved in identifying compliance work related to tax-exempt organizations.

### **The CP&C function's Issue Identification and Special Review unit**

The CP&C function's Issue Identification group conducts research and analysis to identify compliance gaps, underlying problems, and patterns in data that reveal potential opportunities for improvements or further development. It helps make data-driven decisions using various research models (*e.g.*, queries return information for potential noncompliance). Special Review groups perform quality reviews of randomly selected closed returns.

The unit's process for identifying tax-exempt organizations involved in potentially nonexempt activity is limited to identifying tax compliance strategies using information reported on the Form 990 series information returns. As reported by the GAO in a June 2020 report, the Issue Identification and Special Review unit currently has three separate models that review tax-exempt organization data from filed information returns to identify responses that may indicate noncompliance because they do not meet certain criteria or expected values, such as exceeding a dollar threshold.<sup>37</sup> The models score each return on the likelihood that it is not in

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<sup>35</sup> Civil fraud results in a remedial action taken by the Government, such as assessing the correct tax and imposing civil penalties as an addition to tax. Criminal fraud results in a punitive action with penalties consisting of fines or imprisonment. In criminal cases, the Government must present sufficient evidence to prove guilt beyond a reasonable doubt. In civil fraud cases, the Government must prove fraud by clear and convincing evidence. A tax fraud offense may result in both civil and criminal penalties.

<sup>36</sup> TIGTA, Report No. 2023-10-001, *More Information Is Needed to Make Informed Decisions on Streamlined Applications for Tax Exemption* (Oct. 2022).

<sup>37</sup> GAO, GAO-20-454, *Tax Exempt Organizations: IRS Increasingly Uses Data in Examination Selection, but Could Further Improve Selection Processes* (June 16, 2020).

compliance. The GAO recommended several actions that the IRS could take to improve this process. Issue Identification and Special Review unit management informed us that it is in the process of making changes to the Form 990 series queries based on the GAO's recommendations.

### **The CP&C function's Classification and Case Assignment unit**

The CP&C function's Classification and Case Assignment unit classifies returns, referrals, and claims to determine if they warrant examination or compliance checks. Based on prior TIGTA audits as well as our review of current policies and procedures and discussions with CP&C management, we determined that the Classification and Case Assignment unit has sufficient procedures and processes to identify and develop referrals that have indications of substantial nonexempt, fraudulent, or illegal activities, including terrorism. In addition to the Internal Revenue Manual, classifiers use desk guides that explain the processes for assessing the examination potential of referrals. The TE/GE Division has also provided periodic terrorism awareness as well as fraud and illegal activities identification and development training sessions, including written guidance, that provide classifiers with additional information and resources needed to properly evaluate referrals and identify potential fraud and other illegal activities.

### **The EO function's Examinations unit**

The EO function's Examinations unit's primary objectives are to determine if 1) the organization is organized and operated in accordance with its exempt purpose, 2) the organization has properly filed all required returns and forms, and 3) the organization or its related entities are liable for other taxes.

Although an EO function examiner is concerned with the determination of the civil tax liability or applicable penalties, there are procedures and guidelines in place for identifying and considering tax fraud, identifying the elements of fraud, and developing fraud issues. In addition, should EO function examiners come across potential fraud issues during their examinations, they work with the Financial Investigations Unit, which serves as a resource to help examiners develop the case as a referral to CI for investigation of potential criminal fraud.<sup>38</sup>

In February 2021, TIGTA reported that EO function leadership and examiners believed there is sufficient information during examinations to detect tax-exempt organization noncompliance. EO function examiners use various tools such as internal sources, including the taxpayer filing and compliance history database and determination administrative files as well as external sources, such as tax law research and Internet websites.<sup>39</sup> Furthermore, EO function examiners can also consult the Knowledge Management Network, which provides guidance on various topics, to ensure that they properly developed issues and consistently applied the law.

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<sup>38</sup> A program within the EO function that includes forensic investigators who perform forensic investigations and examinations of the most complex exempt organizations and other related activities. The Financial Investigations Unit has designated examiners available as consultants to provide advice during examinations and for developing cases involving potential fraud for eventual referral to CI.

<sup>39</sup> TIGTA, Report No. 2021-10-013, *Obstacles Exist in Detecting Noncompliance of Tax-Exempt Organizations* (Feb. 2021). Although EO function examiners and managers informed TIGTA that the EO function has sufficient information during examinations to detect noncompliance, our report outlines obstacles that the IRS faces in detecting noncompliance of tax-exempt organizations.

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EO function examiners also received several training classes related to the identification of fraud and terrorism. For instance, in March 2019, the EO function coordinated with CI and provided general terrorism awareness training to Examinations unit and Government Entities/Shared Services employees. In October 2019, the EO function's Examinations unit basic training included training modules that addressed fraud identification and the fraud referral process. In the spring/summer 2020, training was provided to EO function examiners about the processes to identify, develop, and refer potential criminal fraud to CI. The TE/GE Division has delivered multiple training modules virtually in FY 2020 on various aspects of addressing the support of fraud identification and development as it relates to the tax law. Finally, the Financial Investigations Unit has regularly provided area or group level presentations on fraud development topics.

## Appendix I

### Detailed Objective, Scope, and Methodology

The overall objective of this audit was to assess the IRS's ability to identify tax-exempt organizations potentially involved in illegal or nonexempt activities and the processes in place when potential illegal or nonexempt activities are identified. To accomplish our objective, we:

- Determined whether the IRS effectively works with Federal and State law enforcement and other third parties to identify tax-exempt organizations that have engaged in potentially illegal activity.
- Identified processes and procedures for how CI coordinates with individual State AG Offices, State tax departments, other Federal agencies, and local law enforcement. We also determined that CI received 10 referrals from external stakeholders during FYs 2018 through 2020.
- Determined the EO function's role in coordinating with States on receiving referrals.
- Interviewed a judgmental sample of five State charity regulators to determine their role in identifying potentially illegal activities and any collaboration with the IRS.<sup>1</sup>
- Determined the effectiveness of the IRS's use of referrals in identifying potentially illegal activity by tax-exempt organizations.
- Reviewed the CP&C function's classification process when potential fraud or illegal activity referrals are received (internal and external) in the Classification and Case Assignment unit.
- Reviewed judgmental samples of 16 referrals from State AG Offices or other State law enforcement offices and 30 other referrals from the referral database to determine whether the IRS's assessment of those referrals were properly researched and documented.
- Determined whether the IRS has processes in place to identify if any substantial part of a tax-exempt organization's activities is for a nonexempt purpose.

### **Performance of This Review**

This review was performed with information obtained from CI headquarters in Washington, D.C.; the EO function's Determinations unit in Cincinnati, Ohio; the Examinations unit in Brooklyn, New York; and the CP&C function located in Washington, D.C., during the period March 2021 through July 2022. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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<sup>1</sup> A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population.

Major contributors to the report were Bryce Kisler, Acting Assistant Inspector General for Audit (Management Services and Exempt Organizations); Carl Aley, Director; Cheryl Medina, Audit Manager; Sean Morgan, Lead Auditor; Kevin Jones, Auditor; and Michael McGovern, Auditor.

### **Validity and Reliability of Data From Computer-Based Systems**

We performed tests to assess the reliability of data from the referral database and CI's Criminal Investigation Management Information System. We evaluated the data by 1) performing electronic testing of required data elements, 2) reviewing existing information about the data and the system that produced them, and 3) interviewing agency officials knowledgeable about the data. We initially determined that the data from both systems were sufficiently reliable for the purposes of this report. However, during our analysis of the referral database data, we determined that some of the fields were inaccurately completed, which affected the reliability of the data.

### **Internal Controls Methodology**

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: the Classification and Case Assignment unit's policies, procedures, and practices for processing referrals. To assess these controls, we selected and reviewed judgmental samples of Classification and Case Assignment unit referral case files to determine if the referrals were sufficiently researched and properly documented. We also interviewed personnel from several IRS offices to obtain an understanding of the policies and procedures for processing referrals alleging illegal or nonexempt activities.

## Outcome Measure

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to Congress.

### **Type and Value of Outcome Measure:**

- Reliability of Information – Actual; 3,956 referral cases with inaccurate or incomplete information on the referral database (see Recommendation 2).

### **Methodology Used to Measure the Reported Benefit:**

#### **Final dispositions inaccurately coded**

We obtained an extract of closed EO function Examinations unit referrals from FYs 2018 through 2020 from which we identified 3,726 referrals alleging potentially fraudulent or illegal activities. We analyzed the referral database field "Final Action Code Description" and determined that 42 referrals were selected for an examination or compliance check. However, we did not identify any completed examinations or compliance checks when we researched the closed EO function examination data. We subsequently received the disposition information for these 42 referrals from Classification and Case Assignment unit management.

These 42 inaccurate coding entries for the final dispositions of referral cases are comprised of:

- 27 referrals recommended for examination. However, 23 of these 27 cases were incorrectly coded by the classifier and were not actually intended for an examination. For the remaining four referrals, the classifiers intended to recommend them for examination but selected the incorrect code on the referral database and forwarded them for closing instead of unassigned inventory.
- 15 referrals incorrectly recommended for compliance checks on the referral database. Instead, classifiers should have coded 14 of the 15 cases as not selected for examination. The final case was intended for examination, but the classifier incorrectly coded it as a recommended compliance check and then forwarded the case for closing in error.

#### **Conflicting final disposition information**

We obtained an extract of closed EO function Examinations unit referrals from FYs 2018 through 2020 with 15,522 unique referral cases. We compared the referral database fields "Final Action Code Description" and "Determination Description" to identify instances in which the entries in both fields are not the same. The 980 closed referral cases that we identified as having conflicting final disposition information are comprised of 531 cases in FY 2018, 202 cases in FY 2019, and 247 cases in FY 2020.

**Incomplete field entries**

We obtained an extract of closed EO function Examinations unit referrals from FYs 2018 through 2020 with 15,522 unique referral cases. We identified 2,934 required referral database fields that were blank, comprised of 2,743 "Allegation" fields and 191 "Determination Description" fields.

## Appendix III

### Previous TIGTA and GAO Reports

During FYs 2018 through 2021, TIGTA and the GAO have issued several reports that reviewed the processes in place to identify organizations with activities that are potentially illegal or substantially different than their approved nonexempt purposes. The following are summaries of each report's findings.

#### ***TIGTA, Report No. 2021-10-013, *Obstacles Exist in Detecting Noncompliance of Tax-Exempt Organizations* (Feb. 2021)***

In February 2021, TIGTA reported that, although referrals may help detect tax schemes, they do not always lead to productive cases. In addition, the chances of an examination for tax-exempt organizations is lower when compared to examination rates of businesses and individuals. In FY 2020, the TE/GE Division began implementing a new process to improve tracking the results of noncompliance issues identified from examinations. The new process allows the CP&C function to compare examination results with the specific potential noncompliance issues initially identified and adjust the criteria used to detect potential noncompliance issues as necessary. TIGTA reviewed a sample of closed EO function examination cases during FY 2019 and determined that examiners generally followed examination procedures. EO function examiners and managers stated that the EO function's Examinations unit has sufficient information during examinations to detect noncompliance.

#### ***TIGTA, Report No. 2021-10-005, *Consolidation of Examination Case Selection and Assignment in the Tax Exempt and Government Entities Division Created Benefits, but Additional Improvements Are Needed* (Dec. 2020)***

In December 2020, TIGTA reported that the TE/GE Division's implementation of the CP&C function to consolidate examination identification, planning, assignment, and monitoring helped create additional benefits, such as reducing the potential for bias in case selection. In addition, the CP&C function implemented processing changes that decreased processing time for classifying EO function Examinations unit referrals and began implementing a tracking system for all assigned case inventory.

#### ***GAO, GAO-20-454, *Tax Exempt Organizations: IRS Increasingly Uses Data in Examination Selection, but Could Further Improve Selection Processes* (June 16, 2020)***

In June 2020, the GAO reported that the IRS has not fully implemented or documented internal controls in its established processes for analyzing data for EO function examination selection. Primary findings included that: 1) the IRS has not defined measurable objectives for using data to select returns for examination; 2) the IRS's models have deficiencies affecting the validity and reliability of return scoring and selection; 3) the IRS did not consistently document the processing and use of data in decision-making on examination selection; and 4) the IRS does not regularly evaluate examination selection. The GAO made 13 recommendations, including that the IRS establish objectives, revise model documentation, fully document processing and

use data in decisions, and regularly evaluate examination selection. The IRS agreed and is in the process of implementing all but one recommendation.

**TIGTA, Report No. 2019-10-011, *Review of Processes to Identify and Assist in Investigations of Tax-Exempt Organizations With Potential Links to Terrorism* (Feb. 2019)**

In February 2019, TIGTA reported that the TE/GE Division created processes to identify and assist other Government agencies with the investigation of tax-exempt organizations with potential terrorist links. TIGTA identified improvements needed to identify and follow up on tax-exempt organizations with potential links to terrorism when processing and examining tax-exempt returns and when reviewing referrals. IRS management took corrective actions based on TIGTA's recommendations, including developing procedures to timely forward monthly reports of tax-exempt organizations that match a terrorist watch list used by the IRS and to provide terrorism awareness training to general program Examination personnel. Additionally, classifiers received training on the requirements for consistently documenting referral case files with the actions taken, research performed, and reasons for/against decisions on cases forwarded to the Political Activities Referral Committee (PARC).

**TIGTA, Report No. 2019-10-006, *Review of the Processing of Referrals Alleging Impermissible Political Activity by Tax-Exempt Organizations* (Oct. 2018)**

In October 2018, TIGTA reported that the IRS created the PARC with three experienced managers to independently review referrals containing allegations of impermissible political activity and determine if examinations were warranted. TIGTA reported that, while the TE/GE Division made progress in evaluating high-profile referrals alleging impermissible political activity, it did not ensure that all referrals forwarded to the PARC included thorough and complete case file documentation. Per the report, the IRS has emphasized the requirements for consistently documenting related research in the referral database for cases forwarded to the PARC. The IRS updated its guidance pertaining to PARC decisions on whether examinations are warranted. In addition, the IRS implemented periodic quality reviews for cases forwarded to the PARC to provide reasonable assurance that documentation requirements are met.

Management's Response to the Draft Report



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

August 31, 2022

MEMORANDUM FOR HEATHER M. HILL  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Sunita B. Lough Sunita B. Lough Digitally signed by Sunita B. Lough  
Date: 2022.09.01 16:29:39 -04'00'  
Commissioner,  
Tax Exempt and Government Entities Division (TE/GE)

SUBJECT: Draft Audit Report – Review of the IRS's Enforcement Program  
for Tax Exempt Organizations That Participate in Illegal or  
Nonexempt Activities (Audit # 202110025)

Thank you for the opportunity to review your draft report titled: "Review of the IRS's Enforcement Program for Tax Exempt Organizations That Participate in Illegal or Nonexempt Activities (Audit # 202110025)." The mission of the Tax Exempt and Government Entities Division (TE/GE) is to provide our 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. To that end, we appreciate your acknowledgement in the report that the IRS has in place processes to identify whether a tax-exempt organization engages in substantial activities that do not further tax-exempt purposes.

Each year, the Compliance Planning and Classification (CP&C) function within TE/GE receives thousands of referrals alleging noncompliance. Referrals are entered into the Reporting Compliance Case Management System (RCCMS). As the referrals are processed, allegations of noncompliance are considered by a classifier, and the organization is evaluated for potential illegal or nonexempt activities and examination potential. Based on the research and findings, the classifier makes a determination to either select the organization for examination or not. That determination along with the documentation supporting the decision are recorded in RCCMS.

We welcome your review of our process for evaluating referrals, including those that allege fraudulent or illegal activities. As stated in the report, few of these referrals have ultimately merited examination because, most commonly, there is insufficient corroborating evidence for the allegation. You sampled referrals that alleged potentially fraudulent or illegal activities and found all were sufficiently researched. Nevertheless, we continually strive to improve our procedures and appreciate your recommendations

**Review of the IRS's Enforcement Program for Tax-Exempt  
Organizations That Participate in Illegal or Nonexempt Activities**

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to ensure accurate and complete data is included in the system of recordation for all referrals.

In response to your first recommendation, we plan to use group and area meetings as well as case and workload reviews as opportunities to stress the importance of including documentation supporting their decisions in classifiers' case files. While we encourage classifiers to include documentation which supports their decision and adds value, the documentation included in a case is at the classifier's professional judgment. Including too much information is counterproductive and not efficient. In addition, some of the research used during the classification process is from commonly used internal systems and is readily available to anyone working the case so documenting such materials in the case file would be redundant.

Classification has initiated discussions with our Business Systems Planning (BSP) function to explore the feasibility of changes to RCCMS, such as making more fields mandatory, to ensure required fields are completed and accurate data are input when classifiers update or close cases. We plan to work with BSP and review the RCCMS fields used for referrals to determine if any may be eliminated or changed to avoid redundancy and conflicting information in similar fields. With the upcoming conversion to the IRS-wide system, Enterprise Case Management (ECM), major programming changes to RCCMS are no longer being considered, but we will identify possible alterations that may be made to the current system to improve the accuracy of data identified on RCCMS pending transition to ECM. Finally, we concur with the outcome measure, and will take the corrective actions described below to promote the input of accurate and complete data.

We appreciate the opportunity to review and comment on the draft report. Attached is a detailed response to your recommendations. If you have any questions, you or your staff may contact me, or Rob Malone, Director, Exempt Organizations and Government Entities, TE/GE at [Robert.Malone@irs.gov](mailto:Robert.Malone@irs.gov) or Adrian F. Gonzalez, Director, Compliance Planning and Classification, TE/GE at [Adrian.F.Gonzalez@irs.gov](mailto:Adrian.F.Gonzalez@irs.gov).

Attachment

**Review of the IRS's Enforcement Program for Tax-Exempt  
Organizations That Participate in Illegal or Nonexempt Activities**

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Attachment

**Corrective Actions for TIGTA Audit Draft Report –  
Review of the IRS's Enforcement Program for Tax Exempt Organizations That  
Participate in Illegal or Nonexempt Activities (Audit # 202110025)**

**RECOMMENDATION 1:**

The Director, CP&C, should ensure that Classification managers periodically emphasize to classifiers the importance of including supporting documentation in case files for selecting or not selecting referrals for examination.

**CORRECTIVE ACTION:**

The Director, CP&C, will ensure Classification managers periodically emphasize to classifiers the importance of including supporting documentation in case files for selecting or not selecting referrals for examination.

**IMPLEMENTATION DATE:**

February 15, 2023

**RESPONSIBLE OFFICIAL(S):**

Director, CP&C, TE/GE

**CORRECTIVE ACTION MONITORING PLAN:**

IRS will monitor this corrective action as part of our internal management system of controls.

**RECOMMENDATION 2:**

The Director, CP&C, should determine the feasibility of making changes to referral database system controls to ensure that required fields are completed and accurate data are input when classifiers update/close cases.

**CORRECTIVE ACTION:**

The Director, CP&C will determine the feasibility of making changes to referral database system controls to ensure that required fields are completed and accurate data are input when classifiers update/close cases.

**IMPLEMENTATION DATE:**

March 15, 2023

**RESPONSIBLE OFFICIAL(S):**

Director, CP&C, TE/GE

**Review of the IRS's Enforcement Program for Tax-Exempt  
Organizations That Participate in Illegal or Nonexempt Activities**

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**CORRECTIVE ACTION MONITORING PLAN:**

IRS will monitor this corrective action as part of our internal management system of controls.

**RECOMMENDATION 3:**

The Director, CP&C, should review the fields on the referral database and determine if any may be eliminated to avoid confusion, conflicting information in similar fields, and redundancy.

**CORRECTIVE ACTION:**

The Director, CP&C will review the fields on the referral database and determine if any may be eliminated.

**IMPLEMENTATION DATE:**

April 15, 2023

**RESPONSIBLE OFFICIAL(S):**

Director, CP&C, TE/GE

**CORRECTIVE ACTION MONITORING PLAN:**

IRS will monitor this corrective action as part of our internal management system of controls.

**Abbreviations**

AG	Attorney General
CI	Criminal Investigation
CP&C	Compliance Planning and Classification
EO	Exempt Organizations
FY	Fiscal Year
GAO	Government Accountability Office
IDRS	Integrated Data Retrieval System
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
NASCO	National Association of State Charity Officials
PARC	Political Activities Referral Committee
TE/GE	Tax Exempt and Government Entities
TIGTA	Treasury Inspector General for Tax Administration



**To report fraud, waste, or abuse,  
call our toll-free hotline at:**

(800) 366-4484

**By Web:**

[www.treasury.gov/tigta/](http://www.treasury.gov/tigta/)

**Or Write:**

Treasury Inspector General for Tax Administration

P.O. Box 589

Ben Franklin Station

Washington, D.C. 20044-0589

Information you provide is confidential, and you may remain anonymous.