

# TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



## **Obstacles Exist in Detecting Noncompliance of Tax-Exempt Organizations**

February 17, 2021

Report Number: 2021-10-013

## Why TIGTA Did This Audit

This audit was initiated at the request of a member of the House Committee on Ways and Means. The overall objective was to review the IRS's policies and audit procedures to identify improper conduct by tax-exempt organizations and determine whether the IRS has sufficient information to combat abuse and enforce Federal tax laws.

## Impact on Taxpayers

The Exempt Organizations (EO) function Examinations unit is responsible for oversight of tax-exempt organizations' compliance with tax laws. If the EO Examinations unit does not follow established procedures and effectively identify noncompliance, unscrupulous taxpayers may conduct abusive schemes using tax-exempt organizations for their own financial gain. This could cause taxpayers to question the integrity of all tax-exempt organizations and affect the amount of charitable contributions made to these important entities.

## What TIGTA Found

Information reported on tax-exempt organizations' returns does not always indicate noncompliance; therefore, the IRS relies heavily on referrals to identify abusive schemes. However, TIGTA found that although referrals may help detect tax schemes, they do not always lead to productive cases. In addition, the chances of examination for tax-exempt organizations is lower when compared to examination rates of businesses and individuals. For Fiscal Year (FY) 2019, the chance of examination for exempt organizations was one in 742, compared to one in 156 for businesses and one in 226 for individual taxpayers. Further, churches and certain other religious organizations are not required to file annual information returns making it difficult to track the activities of these organizations to identify noncompliance. For FY 2019, the chance of examination for churches was about one in 5,000.

The Compliance Planning and Classification function is responsible for identifying and selecting EO Examination cases with potential noncompliance issues. In FY 2019, 20 percent of tax-exempt organization returns selected for examination were closed without an examination being completed, resulting in an inefficient use of resources. For examinations that are completed, there is currently no formal feedback mechanism in place to track the results of each specific noncompliance issue identified. However, the IRS is implementing a new process to improve issue tracking.

Employees are encouraged to submit ideas for future examinations through an online submission site. During our interviews with EO examiners and managers, TIGTA learned that, with the exception of receiving an acknowledgement notice, employees who make submissions do not receive any kind of feedback or updates on them. This lack of feedback may discourage employees from submitting ideas, potentially resulting in missed opportunities to identify potential noncompliance.

TIGTA reviewed a random sample of 53 of the 3,675 closed EO Examination cases during FY 2019 and determined that examiners generally followed examination procedures. EO examiners and managers stated that the EO function has sufficient information during examinations to detect noncompliance.

## What TIGTA Recommended

TIGTA recommended that the Compliance Planning and Classification function provide feedback to examiners who have submitted issues through the online submissions portal. The IRS agreed with the recommendation and plans to develop a process to provide feedback to examiners who have submitted issues through the online submissions portal, without violating internal control separation of duties for examination selection.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

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

**WASHINGTON, D.C. 20220**

February 17, 2021

**MEMORANDUM FOR:** COMMISSIONER OF INTERNAL REVENUE

A handwritten signature in blue ink that reads "Michael E. McKenney".

**FROM:** Michael E. McKenney  
Deputy Inspector General for Audit

**SUBJECT:** Final Audit Report – Obstacles Exist in Detecting Noncompliance of  
Tax-Exempt Organizations (Audit # 201910021)

The overall objective of this review was to review the Internal Revenue Service's (IRS) policies and audit procedures to identify improper conduct by tax-exempt organizations and determine whether the IRS has sufficient information to combat abuse and enforce Federal tax laws. This review was requested by Representative Brad Schneider, a member of the House Committee on Ways and Means. It is part of our Fiscal Year 2021 Annual Audit Plan, and addresses the major management and performance challenge of *Improving Tax Reporting and Payment Compliance*.

Management's complete response to the draft report is included as Appendix III.

If you have any questions, please contact me or Heather M. Hill, Assistant Inspector General for Audit (Management Services and Exempt Organizations).

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## **Background**

The Exempt Organizations (EO) function is part of the Internal Revenue Service's (IRS) Tax Exempt and Government Entities (TE/GE) Division. The EO function's mission is to provide EO 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. The EO Examinations unit, within the EO function, has important responsibilities for both the oversight of regulatory compliance with tax-exempt requirements as well as compliance with tax laws. The primary objectives for the examination of an exempt organization 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.

Most tax-exempt organizations are required to file an annual Form 990-series information return or notice.<sup>1</sup> According to IRS Statistics of Income Division data, as of Fiscal Year (FY) 2019, the IRS recognized approximately 1.9 million tax-exempt organizations and received in FY 2019 almost 1.6 million tax-exempt return filings.<sup>2</sup> Representative Brad Schneider, a member of the House Committee on Ways and Means, asked the Treasury Inspector General for Tax Administration (TIGTA) to review the IRS's policies and audit procedures to identify improper conduct by tax-exempt organizations and determine whether the IRS has sufficient information to combat abuse and enforce Federal tax laws. This audit focused on the information available to examiners during an examination of organizations' annual information return filings. We are performing a separate review of the adequacy of information provided by organizations during the process of applying for tax-exempt status.<sup>3</sup>

### **EO examination case selection**

On May 1, 2017, the TE/GE Division realigned the issue identification, planning, classification, and case delivery processes from five TE/GE functions into the centralized Compliance Planning and Classification (CP&C) function.<sup>4</sup> TIGTA recently reported that because IRS management did not develop performance metrics to measure progress towards achieving reorganization goals,

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<sup>1</sup> Form 990, *Return of Organization Exempt From Income Tax*, Form 990-EZ, *Short Form Return of Organization Exempt From Income Tax*, Form 990-PF, *Return of Private Foundation*, Form 990-N, *Electronic Notice (e-Postcard) for Tax-Exempt Organizations Not Required to File Form 990 or Form 990-EZ*, and Form 990-T, *Exempt Organization Business Income Tax Return*. Not all types of tax-exempt organizations are required to file annual information returns; for example, churches have no filing requirements.

<sup>2</sup> Includes the Form 990 Series; Form 4720, *Excise Tax Return of Charities and Other Persons*; Form 5227, *Split-Interest Trust Information Return*, and Form 8872, *Political Organization Report of Contributions and Expenditures*. A fiscal year is 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>3</sup> TIGTA, *2021 Annual Audit Plan - Tax-Exempt Compliance for Organizations That Filed the Streamlined Application for Recognition of Exemption Under Section 501 (c)(3)* (202110017).

<sup>4</sup> Classification is the process of determining whether a return should be selected for compliance activities, what issues should be the primary focus of the compliance activity, and the type of compliance activity that should be conducted.

## Obstacles Exist in Detecting Noncompliance of Tax-Exempt Organizations

TE/GE Division leadership cannot determine if the CP&C function improved the effectiveness and efficiency of identifying, planning, classifying, and monitoring examination workload.<sup>5</sup>

The CP&C function is responsible for developing EO Examinations' work plan, identifying returns for examination, and classifying pre-identified examination issues. CP&C sorts EO Examinations' inventory into three categories, referred to as portfolios, based on how they identified the work:

**Compliance strategies** - Issues of noncompliance approved by TE/GE Division's Compliance Governance Board and collected through employee input.<sup>6</sup>

**Data-driven approaches** - Enforcement activities resulting from the use of data and queries to select cases based on specified quantitative criteria. The Government Accountability Office recently issued a report on the use of data analytics to identify workload for the EO function.<sup>7</sup>

**Referrals, claims, and other casework** - Includes (1) examinations resulting from referrals received from internal and external sources that allege possible noncompliance for an entity under the TE/GE Division's jurisdiction, and (2) requests for refunds or credits of amounts already assessed and paid, including tax, penalties, interest, or an adjustment of tax paid or credit not previously reported or allowed.

Figure 1 shows the number of EO examination cases closed within each compliance portfolio for FYs 2018 and 2019.

**Figure 1: EO Examination Closures by Compliance Portfolio for FYs 2018 and 2019**

Compliance Portfolio	FY 2018	FY 2019
Total <sup>8</sup>	4,891	3,675
Referrals/Claims/Other	2,793	1,672
Data-Driven Approaches	2,086	1,982
Compliance Strategies <sup>9</sup>	12	21

Source: TIGTA analysis of Returns Inventory and Classification System data.

<sup>5</sup> TIGTA, Ref. No. 2020-10-005, *Consolidation of Examination Case Selection and Assignment in the Tax Exempt and Government Entities Division Created Benefits, but Additional Improvements Are Needed* (December 23, 2020).

<sup>6</sup> The TE/GE Compliance Governance Board serves as the governing body over the identification, selection, assignment, and allocation of resources for all TE/GE Division compliance and enforcement activities and helps ensure that all compliance strategy proposals are reviewed and discussed prior to any case selection.

<sup>7</sup> Government Accountability Office, GAO-20-454, *Tax Exempt Organizations – IRS Increasingly Uses Data in Examination Selection, but Could Further Improve Selection Processes* (June 2020).

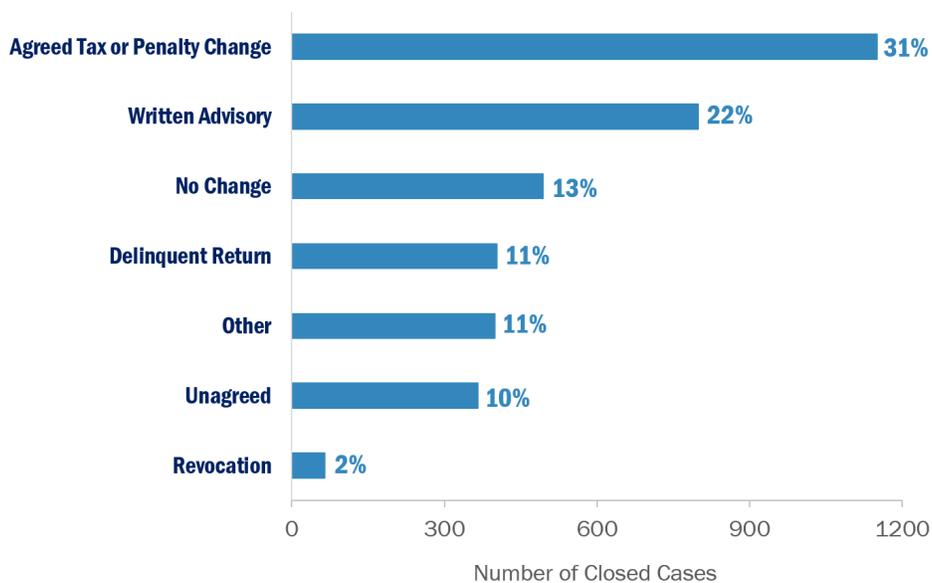
<sup>8</sup> A combination of factors contributed to the EO function's reduced examination closures for FY 2019, including delayed delivery of inventory due to case inventory management system problems, the 2018-2019 Federal Government shutdown, and the temporary reassignments of EO examiners to other areas within the EO and CP&C functions.

<sup>9</sup> The compliance strategies portfolio was created in FY 2018. Each compliance strategy has to be researched, developed, and approved before examinations can be assigned and worked. As a result, the FYs 2018 and 2019 numbers are low; however, EO Examination's FY 2020 Workplan shows a significant increase for this portfolio.

**EO examination process**

As defined in Section 7602 of the Internal Revenue Code, an examination is a review of a return and supporting books and records. EO may examine a tax-exempt organization to determine the continuing tax-exempt status of an organization and whether the organization paid all appropriate tax liabilities. During the examination, examiners interview taxpayers and request documentation and other information needed to complete the review. Once completed, the examiner discusses the results of the examination with the taxpayer and closes the case.<sup>10</sup> During FY 2019, the EO Examinations unit closed 3,675 examination cases. Figure 2 shows the percentage of EO examination cases closed within each examination outcome category.

**Figure 2: Percentage of Fiscal Year 2019 EO Examination Cases Closed by Examination Outcome<sup>11</sup>**



Source: TIGTA analysis of Returns Inventory and Classification System data.

The majority (53 percent) of examinations resulted in an agreed tax or penalty change or a written advisory. About two percent resulted in the revocation of an organization’s tax-exempt status.

<sup>10</sup> See Appendix II for a more detailed explanation of the EO examination process.

<sup>11</sup> A written advisory is issued to a tax-exempt organization when an exam results in no change to exempt status, but identified some aspect of an organization’s activities, which if it continues or grows, may jeopardize the organization’s exempt status. The “Other” category includes Regulatory/Revenue Protection when an examination is closed with an agreed claim disallowance, a reduction to a net operating loss that does not affect the tax liability, the closing of a barred statute, or a change to income and/or deduction items reported on the return with no tax adjustment.

## Results of Review

### The IRS Faces Obstacles in Detecting Noncompliance of Tax-Exempt Organizations

An organization must be organized and operated in a way that meets the requirements of the subsection of Section 501(c) under which it is recognized or claims exempt status. The requirements vary depending on which subsection is applicable (*e.g.*, Section 501(c)(3) charities; Section 501(c)(4) social welfare organizations), and require the application of the relevant law to the facts and circumstances of the particular organization under audit. Moreover, tax abuse continues to occur within the tax-exempt sector because unscrupulous organizations may use elaborate or fraudulent schemes to conceal their illegal activities, making such abuse difficult to identify. The complexity of the tax law, limited examination resources, and a lack of filing requirements for some types of entities make identifying tax abuse by tax-exempt organizations challenging.

#### **The IRS relies heavily on referrals to identify abusive schemes**

Identifying noncompliance and performing examinations of tax-exempt organizations requires in-depth training, experience, and knowledge. Tax-exempt organizations encompass a wide range of entities from animal shelters and veterans organizations, to hospitals and colleges, each with unique criteria for tax-exempt approval and continued tax-exempt status. The complexity of the tax law provides unscrupulous entities opportunities to abuse the tax system and commit fraud.

**Return information alone does not always identify noncompliance.** Information reported on an organization's returns may not have been uncommon, prohibited, or raised concerns of potential noncompliance at the time of filing. For example, in FY 2019, a whistleblower alerted Federal officials about an abusive scheme, referred to as the college admissions scandal, involving a tax-exempt organization. The organization's returns did not include any information considered uncommon or prohibited under tax law. It was the additional information provided by the whistleblower that led to an in-depth review of the tax-exempt organization, and ultimately the uncovering of an abusive scheme that had been going on for years.

In addition, some illicit activities may be easier to identify from the perpetrator's personal or business tax returns and other financial records instead of the return and other records of the tax-exempt organization used in the tax abuse. In other cases, identification of noncompliance could be best identified by simultaneously reviewing documentation from multiple filers; however, the IRS would need a basis to associate seemingly unrelated entities to accomplish this analysis.

Based on interviews with employees and our own research, it does not appear that requiring additional information on returns would make identifying abusive schemes easier. We spoke with EO Examination function directors, managers, and examiners to solicit ideas for information that could be used to identify potential noncompliance. Overall, they did not think additional return information would assist with identifying abusive schemes. Improper activity, such as

illicit contributions to an exempt organization, would not be evident based on the returns alone, and would require additional investigation on a case-by-case basis.

In addition, we researched other sources of information that may help uncover unscrupulous taxpayers during examinations. We compared the information reported on Form 990 with the information on Form 1120, *U.S. Corporation Income Tax Return*, and did not identify any information gaps that impaired detection of exempt organization noncompliance. We also researched the filing requirements for exempt organizations in six States and determined that each State has unique filing requirements, which makes it difficult for the IRS to develop a standardized information request for all the States to help identify potential noncompliance.

**Referrals may help detect tax schemes, but they do not always lead to productive cases.** A referral is a complaint from the public or a Federal or State regulatory agency about potential noncompliance by an exempt organization. Given the challenges of detecting complex tax schemes, TE/GE Division leadership told us they rely on their referral program to identify such behavior. Whistleblowers or other third parties can have insider’s knowledge and access to information that would not be available to the IRS.

Although referrals are a valuable source of information, especially for the detection of fraudulent activity, examinations initiated from referrals are more likely to be closed with no changes to the return than those from other sources, such as compliance strategies and data-driven approaches. The IRS considers examined returns with recommended adjustments more productive than examinations that result in no changes. Examinations that result in no change to the organization’s tax-exempt status or tax liability cause unnecessary burden on taxpayers and IRS resources. Figure 3 compares the no-change rates for examinations from referrals to examinations from other sources for the past two fiscal years.

**Figure 3: Examination Closures and No-Change Rates for Referral and Non-Referral Cases<sup>12</sup>**

	Closed Examinations	No Changes	No-Change Rate
<b>FY 2018</b>			
Referrals	962	174	18%
Non-referrals	3,929	592	15%
<b>FY 2019</b>			
Referrals	566	86	15%
Non-referrals	3,109	408	13%

*Source: TIGTA analysis of Returns Inventory and Classification System data.*

Compared to examinations from other sources, the no-change rate for examinations from referrals was 20 percent higher (3 percentage points) in FY 2018 and 16 percent higher (2 percentage points) in FY 2019. However, although only 20 percent of the FY 2018 examination closures originated from referrals, they resulted in 40 percent of the total revocations of tax-exempt status for that year. For FY 2019, 15 percent of closed examinations were from referrals and accounted for 16 percent of the total revocations that year. These

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<sup>12</sup> Closed referral examinations include additional cases closed as a result of a referral, including related return pick-ups and delinquent returns secured.

results suggest that even though referrals may help uncover fraudulent activity or result in significant changes, like revocations of tax-exempt status, the IRS should continue balancing examinations initiated from other sources with those originated from referrals.

**The IRS conducts comparatively few examinations of exempt organizations**

The more examinations that take place, the greater likelihood of detecting noncompliance; however, resources are limited. During FY 2019, there were almost 1.5 million Form 990 series returns and notices filed; however, the EO function examined approximately 2,000 (0.13 percent) Form 990 series returns during the same year.<sup>13</sup> Put another way, an exempt organization’s chance of examination was one in 742. Meanwhile, although still low, the chances of examination for other kinds of entities is materially higher than that of exempt organizations. Figure 4 shows that businesses were almost five times more likely to be examined than exempt organizations and individual taxpayers were more than three times more likely to be examined.

**Figure 4: FY 2019 Examination Percentages for Tax-Exempt Organization, Corporation, and Individual Returns**

Return Type	Returns Filed	Returns Examined	Percent Examined
990 Series (Tax-Exempt Organization)	1,491,002	2,009	0.13%
1120 Series <sup>14</sup> (Corporation)	2,101,462	13,472	0.64%
1040 Series <sup>15</sup> (Individual)	154,094,555	680,543	0.44%

Source: Publication 6292, *Fiscal Year Return Projections for the United States: 2020-2027, Spring 2020*; TIGTA analysis of Returns Inventory and Classification System data; and IRS’s *Statistics of Income data*.

In order for the EO Examinations unit’s examination rate to be comparable to that of businesses, it would have to complete five times as many examinations as it does now. The unit would have to complete more than three times as many examinations to reach the examination rate of individuals. The relatively low examination rate may embolden unscrupulous



<sup>13</sup> The 1.5 million is Form 990 series returns only and does not include Forms 4720 or 8872.

<sup>14</sup> Form 1120, *U.S. Corporation Income Tax Return*; Form 1120-C, *U.S. Income Tax Return for Cooperative Associations*; Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*; Form 1120-H, *U.S. Income Tax Return for Homeowners Associations*; Form 1120-L, *U.S. Life Insurance Company Income Tax Return*; 1120-ND, *Return for Nuclear Decommissioning Funds and Certain Related Persons*; Form 1120-PC, *U.S. Property and Casualty Insurance Company Income Tax Return*; Form 1120-REIT, *U.S. Income Tax Return for Real Estate Investment Trusts*; Form 1120-RIC, *U.S. Income Tax Return for Regulated Investment Companies*; and Form 1120-SF, *U.S. Income Tax Return for Settlement Funds*.

<sup>15</sup> Form 1040, *U.S. Individual Income Tax Return*; Form 1040-NR, *U.S. Nonresident Alien Income Tax Return*; Form 1040NR-EZ, *U.S. Income Tax Return for Certain Nonresident Aliens With No Dependents*; Form 1040-C, *U.S. Departing Alien Income Tax Return*; and Forms 1040-PR and 1040-SS, *U.S. Self-Employment Tax Return (Including the Additional Child Tax Credit for Bona Fide Residents of Puerto Rico)*.

organizations to file returns with missing or erroneous information. It also emphasizes why case selection is particularly important for the EO function.

### **Limited filing requirements and restrictive procedural tax laws for churches and certain other religious organizations create challenges detecting noncompliance**

Per current tax law, churches and certain other religious organizations are not required to file applications for exemption or annual information returns to obtain or maintain their tax-exempt status, making it challenging for the IRS to identify potential noncompliance.<sup>16</sup> There are also special rules imposed by Congress limiting the IRS's authority to conduct certain tax inquiries and examinations of churches.

We identified a population of more than 263,000 churches and other religious organizations that IRS systems showed were not required to file tax-exempt annual information returns with the IRS.<sup>17</sup> Of those, 39 (0.01 percent) organizations had 52 returns examined during FY 2019, which is about a one in 5,000 chance of examination. The EO managers and examiners we interviewed stated that they believe churches' exemptions from filing annual information returns hinders detection of potential noncompliance. The IRS instead relies on other types of returns that churches and religious organizations must file, such as employment tax returns, to identify church noncompliance. The IRS may also identify church noncompliance through referrals.

Congress has also imposed special limitations on how and when the IRS may conduct certain tax inquiries and examinations of churches.<sup>18</sup> The IRS may begin a church tax inquiry only if an appropriate high-level Treasury official reasonably believes, on the basis of facts and circumstances recorded in writing, that an organization claiming to be a church, or a convention or association of churches, may not qualify for exemption.<sup>19</sup> If the reasonable belief requirement is met, the IRS must begin an inquiry by providing a church with written notice containing an explanation of its concerns.<sup>20</sup> The church is allowed a reasonable period in which to respond by furnishing a written explanation to alleviate the IRS's concerns. If the church fails to respond to the inquiry notice within the required time, or if its response is not sufficient, the IRS may issue a second notice informing the church of the need to examine its books and records. If at any time during the inquiry process the church supplies information sufficient to alleviate the concerns of the IRS, the matter will be closed without examination of the church's books and records. The IRS cannot begin a subsequent inquiry or examination of a church for a five-year period unless

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<sup>16</sup> Per Internal Revenue Code Sections 508 and 6033, churches and their integrated auxiliaries, conventions or associations of churches are not required to file applications for exemption or annual information returns to be a tax-exempt organization under section 501(c)(3). There are some religious affiliated organizations, for example religious schools, that are required to file.

<sup>17</sup> This number is an approximation. We did not validate these data due to time constraints. Some of the identified organizations may no longer be active tax-exempt organizations.

<sup>18</sup> Internal Revenue Code § 7611 restricts how the IRS can interact with churches in connection with church tax inquiries and examinations. However, churches may authorize the IRS to consider a claim for refund or request for abatement without following Internal Revenue Code § 7611 procedures by executing a written waiver.

<sup>19</sup> A church tax inquiry is any inquiry to a church (other than an examination) that serves as a basis for determining whether the organization qualifies for tax exemption as a church, or whether it is carrying on an unrelated trade or business or otherwise engaged in activities subject to any Internal Revenue Code tax.

<sup>20</sup> The written notice must also contain the general subject matter of the inquiry and a general explanation of the applicable administrative and constitutional provisions with respect to such inquiry (including the right to a conference with the Secretary before any examination).

the previous inquiry or examination resulted in a revocation, notice of deficiency, assessment, or a request for a significant change in church operations.<sup>21</sup>

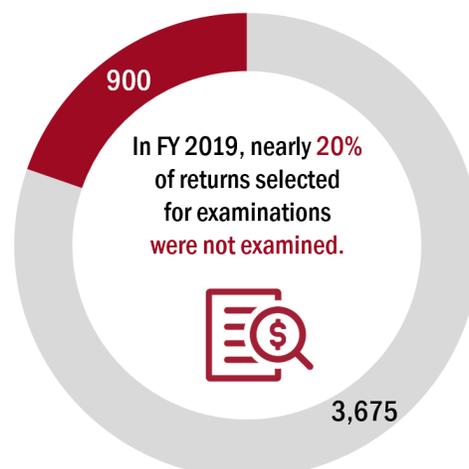
However, without annual returns, there is no way to track the activities of churches and other religious organizations from year to year and there is no return data for the CP&C function to use to identify potential noncompliance. The lack of filing requirements imposed by statute limits the IRS's enforcement capabilities and it could encourage unscrupulous organizations to exploit this information gap.

### Case Identification Can Be Improved

The CP&C function is responsible for identifying and selecting EO Examinations cases with potential noncompliance issues. It does this by performing data analytics of filed information returns, developing issue ideas submitted by EO function employees, and approving internal and external referrals for examination. However, many examination cases were unproductive and there are no processes in place to measure the success of case identification or receive feedback on case selection quality from the examiners.

**Many selected cases were not productive.** Cases identified and selected for examination by the CP&C function that are closed without an examination being completed are referred to as non-examined closures. For example, an examiner may determine that the issues identified by the CP&C function do not have merit or the return is close to its statute of limitations date, so an examination is not warranted.<sup>22</sup> The examiner will "survey" the case, which is closing it without completing an examination, after obtaining manager approval. Figure 5 shows the number of non-examined case closures in FY 2019.

**Figure 5: FY 2019 Exempt Organizations Selected Cases Not Examined**



*Source: TIGTA analysis of Returns Inventory and Classification System data.*

<sup>21</sup> Unless such subsequent inquiry or examination is approved in writing by the Secretary or does not involve the same or similar issues involved in the preceding inquiry or examination.

<sup>22</sup> A statute of limitation is a time period established by law to review, analyze, and resolve taxpayer and IRS tax-related issues.

In FY 2019, the EO Examinations unit did not examine approximately 20 percent of the tax-exempt organization returns selected for examination, resulting in an inefficient use of resources.<sup>23</sup> Examiners and managers spent time reviewing unproductive cases that were surveyed instead of examined. In response to the recent Government Accountability Office report, the IRS agreed to analyze the reasons for non-examined closures and take actions to address them, so we are not making a recommendation for this issue.<sup>24</sup>

Another measure of productivity is the number of completed examinations that result in no changes. The number of examinations resulting in no changes favorably decreased from 15.7 percent in FY 2018 to 13.4 percent in FY 2019. This change represents a 15 percent improvement. However, there is no way to determine the cause of the improvement without additional issue-specific information. The CP&C function is piloting a process to determine whether the potential examination issues identified actually resulted in changes.

**The CP&C function is taking steps to track issue-specific examination results.** Currently, there is no formal feedback mechanism in place between the EO Examinations unit and the CP&C function for EO examiners to provide input on the cases identified and selected for examination. EO examiners close cases at the summary level (*e.g.*, “adjustment”), without tracking the results of each specific noncompliance issue identified. As a result, the CP&C function has no way of knowing if the potential issue(s) identified for the examiners resulted in an adjustment or if other issues identified during the examination resulted in the change. For example, if the CP&C function identified a possible employment tax issue, but the examination resulted in a change due to a separate issue (such as Unrelated Business Income), the overall case would be closed as a “change case” but the CP&C function would have no way of knowing that the employment tax issue was not substantiated. This practice could lead to a mistaken belief that the CP&C function’s methodology for identifying cases for examination led to a related finding of noncompliance.

However, the TE/GE Division is piloting a data grid, which collects the results of examinations by each potential noncompliance issue reviewed. For every examination, the grid lists each potential noncompliance issue identified by the CP&C function. In addition, examiners can add other issues identified during an examination. When examiners close cases, they indicate on the data grid the results for each identified issue, such as no change or assessment. Using the completed data grid, the CP&C function can now compare examination results with the specific potential noncompliance issues initially identified, and adjust the criteria used to detect potential noncompliance issues as necessary. According to IRS management, the TE/GE Division began implementing the data grid for all assigned inventory in September 2020. Because the IRS is updating its processes to improve issue tracking, we are not making a recommendation.

**The CP&C function does not recognize specific employees’ contributions to compliance strategies.** IRS leadership stated that if examiners have ideas or issues for development to be used in identifying future examinations, they are encouraged to submit them through the

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<sup>23</sup> Some of these tax-exempt organizations continued to be examined using a different return filing or subsequent tax period.

<sup>24</sup> Government Accountability Office, GAO-20-454, *Tax Exempt Organizations – IRS Increasingly Uses Data in Examination Selection, but Could Further Improve Selection Processes* (June 2020).

CP&C's online submission portal.<sup>25</sup> Each submission is evaluated and is either rejected, combined with another related submission, or developed into a potential compliance strategy.

In FY 2019, employees submitted 45 EO compliance ideas. During our interviews with EO function examiners and managers, we learned that with the exception of receiving an acknowledgement notice, employees who submit ideas through the online submission portal do not receive any kind of feedback or updates on their submissions. This lack of feedback may discourage employees from submitting ideas, which could potentially result in missed opportunities to identify new compliance strategies with a high potential of identifying noncompliance. For example, one EO Examinations unit group manager stated that without responses [to the submission portal], it leaves a negative feeling with the examiners and takes away from them believing that they are making a difference. Positive reinforcement would encourage employees to submit new ideas and potentially improve future workload selection.

The Director, CP&C, should:

**Recommendation 1:** Provide feedback to examiners who have submitted issues through the online submissions portal, without violating internal control separation of duties for examination selection.

**Management's Response:** The IRS agreed with the recommendation and plans to develop a process to provide feedback to examiners who have submitted issues through the online submissions portal, without violating internal control separation of duties for examination selection.

### Examiners Generally Followed Procedures and Obtained Sufficient Information to Detect Noncompliance of Tax-Exempt Organizations

We reviewed a random sample of EO examination cases closed during FY 2019 and determined that examiners generally followed examination procedures.<sup>26</sup> In addition, per EO function leadership and examiners, the EO function has sufficient information during examinations to detect tax-exempt organization noncompliance once a return is selected for review.

During the course of an examination, examiners have both internal and external information available to them. The initial analysis of a case includes conducting research using various internal IRS sources, such as a taxpayer filing and compliance history database and determination administrative files, if submitted.<sup>27</sup> Examiners also have access to external sources such as the Accurint database for public documents, tax law research including the Internal Revenue Code and legal decisions, and Internet websites.<sup>28</sup> After examiners conduct the initial research and confirm the existence of the CP&C function's pre-identified issues as well as identify any additional potential issues warranting further review, they create a request letter asking for specific items needed from the tax-exempt organization to complete the examination.

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<sup>25</sup> The Issue Submission Portal is an online site where employees can submit ideas about an area of potential noncompliance for the development of a compliance strategy.

<sup>26</sup> See Appendix I for details on our sampling methodology.

<sup>27</sup> When an organization applies for exempt status, the application, related paperwork, and the disposition of the application are retained. This file is referred to as the "determination administrative file."

<sup>28</sup> Accurint is a system used to find people and businesses and their assets.

## Obstacles Exist in Detecting Noncompliance of Tax-Exempt Organizations

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If the EO Examinations unit does not follow established procedures and effectively identify noncompliance, unscrupulous taxpayers may conduct abusive schemes using tax-exempt organizations for their own financial gain. This could cause taxpayers to question the integrity of all tax-exempt organizations and affect the amount of charitable contributions made to these important entities.

We selected a random sample of 53 of the 3,675 cases closed in FY 2019 to determine if examiners were following proper examination procedures. We evaluated our case reviews based on procedural requirements, such as verifying required filings were submitted, thoroughly developing identified issues, and obtaining adequate documentation to complete the examination. We identified minor procedural issues, such as managers not documenting their approval of case closures as required and examiners not completing a specific checklist for private foundations.<sup>29</sup> However, these issues were not material and had no effect on the identification of improper conduct or noncompliance of the organizations being examined.

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<sup>29</sup> Form 5774, *Private Foundation Workpapers*, is a form used to organize the examiner's workpapers, provide a summary of the findings, and provide reminders as to procedures to perform or issues to consider.

## Appendix I

### Detailed Objective, Scope, and Methodology

Our overall objective was to review the IRS's policies and audit procedures to identify improper conduct by tax-exempt organizations and determine whether the IRS has sufficient information to combat abuse and enforce our Federal tax laws. To accomplish our objective, we:

- Identified the EO Examinations unit's policies, procedures, and practices for performing tax-exempt organization examinations and identified and evaluated the information available within the EO Examinations unit to enforce compliance of tax-exempt organizations.
- Selected a stratified random sample of 79 examined information returns (Forms 990, 990-EZ, and 990-PF) from the 3,675 cases closed in FY 2019 and assessed if employees followed procedures to determine continued eligibility for tax-exempt status.<sup>1</sup> This included reviewing any related issues identified during the examination, such as unrelated business income tax – Form 990-T. For our sample, we used a 90 percent confidence level,  $\pm 10$  percent precision rate, an expected error rate of 50 percent, and a minimum overall sample size of 30 cases. Because we did not identify any reportable issues during our review of the sample, we stopped reviewing cases after 53 completed analyses.
- Determined overall EO function examination closures for each of the three examination sources – referrals, compliance strategies, and data-driven models – and determined how feedback is used for case selection.
- Researched other potential sources of information to help identify potential noncompliance.
- Researched the college admissions scandal and determined any actions taken by the IRS to identify future schemes using similar tactics.
- Determined if the IRS has sufficient information to identify potential noncompliance by churches and religious organizations that are not required to file applications for exemption or annual information returns.

Due to the large scope, we limited this audit to information available to examiners during an examination of organizations' annual information return filings. We are performing a separate review of the adequacy of information provided by organizations during the process of applying for tax-exempt status.<sup>2</sup>

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<sup>1</sup> We divided our sample into seven strata based on examination outcomes from Returns Inventory and Classification System data: Strata 1 – No Change, Strata 2 – Revocation, Strata 3 – Delinquent Return, Strata 4 – Written Advisory, Strata 5 – Agreed Tax or Penalty, Strata 6 – Unagreed, Strata 7 – Other.

<sup>2</sup> TIGTA, *2021 Annual Audit Plan - Tax-Exempt Compliance for Organizations That Filed the Streamlined Application for Recognition of Exemption Under Section 501 (c)(3)* (202110017).

### **Performance of This Review**

This review was performed at the IRS National Headquarters in Washington, D.C., and with information obtained from the EO and CP&C function offices during the period December 2019 through September 2020. We also conducted telephone interviews with EO Examinations unit and CP&C function employees in numerous locations. 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 objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Major contributors to the report were Heather M. Hill, Assistant Inspector General for Audit (Management Services and Exempt Organizations), Carl Aley, Director; Cheryl Medina, Audit Manager; Jennifer Burgess, Lead Auditor; and Donald Martineau, Auditor.

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

We performed tests to assess the reliability of data from the Returns Inventory and Classification 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 determined that the data were sufficiently reliable for purposes of this report.

### **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: EO function's policies, procedures, and practices for performing tax-exempt organization examinations. To assess these controls, we selected and reviewed a statistically valid random sample of EO examination unit case files.

## **Appendix II**

### **Exempt Organizations Examination Process**

The EO Examinations unit uses a case inventory management system to create and control EO examination cases. The Internal Revenue Manual provides guidance to examiners on the required procedures to be completed during examinations. When examiners are assigned cases for review, they first perform an initial analysis to determine the scope of the examination. This includes checking the statute of limitations to verify that there is sufficient time to conduct a quality examination, conducting filing checks to determine whether the taxpayer complies with Federal tax and information return filing requirements, documenting the organizational requirements for exemption for the type of organization being examined, and performing additional internal and external research relevant to the case. It also includes evaluating the issues that have been pre-identified during the return's selection process and reviewing the return for any large, unusual, and questionable items. Every EO Examinations unit case is a focused examination limited to these pre-identified issues and large, unusual, and questionable items, unless a full scope examination is warranted for reasons such as fraud or egregious noncompliance. Examiners may expand or reduce the scope of any examination as deemed appropriate or necessary with their managers' concurrence.

The examiner conducts an interview with the taxpayer, analyzes books and records, and assesses internal controls. The examiner reviews and verifies supporting documentation to develop the potential issues identified, researches the applicable tax law, and determines the compliance of the identified issues. The examiner documents the findings and conclusions in workpapers stored in the case inventory management system. Once the issues are developed, the examiner communicates them to the taxpayer and receives the taxpayer's position on the issues. The examiner will then issue a final report, finalize case file workpapers, and close the case to his or her manager for review.

If an examiner identifies indicators of fraud during an examination, and the group manager and TE/GE Division Fraud Specialist agree that the indicators have fraud potential, the examiner will work with a Fraud Technical Advisor to create an action plan for development of the potential fraud. The examiner will proceed with the plan of action until affirmative acts of fraud are established or a determination is made that fraud is no longer an issue. If fraud is substantiated, the case is either referred to Criminal Investigation or closed by the examiner with civil fraud penalties. If no fraud exists, the examiner closes the case following normal closing procedures.

## Appendix III

### Management's Response to the Draft Report



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

January 26, 2021

MEMORANDUM FOR MICHAEL E. MCKINNEY  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Edward T. Killen *Edward T. Killen*  
Acting Commissioner,  
Tax-Exempt and Government Entities Division (TE/GE)

SUBJECT: Draft Report – Obstacles Exist in Detecting Noncompliance of  
Tax-Exempt Organizations  
(Audit # 201910021)

Thank you for the opportunity to review your draft report titled: “Obstacles Exist in Detecting Noncompliance of Tax-Exempt Organizations.” We appreciate your review of this issue and share your concern with ensuring effective identification of noncompliance by tax-exempt organizations. As stated in the report, TE/GE believes its examiners have sufficient information during examinations to detect noncompliance, and we appreciate TIGTA’s acknowledgement that examiners generally follow examination procedures.

TE/GE is focused on continuously improving our ability to provide oversight in an environment where, as your report observes, resources available to conduct audits are limited. The creation of the Compliance, Planning & Classification (CP&C) unit in 2017 reflects this effort as a comprehensive approach to identifying, researching, and monitoring compliance risks using data analytics. TIGTA observes that case identification can be improved, and TE/GE continually works to this end. For instance, as described in the report, TE/GE is piloting a data grid to record issue-specific exam results that CP&C can use to compare exam results with identified compliance issues and adjust criteria as necessary.

TIGTA notes abusive or illegal activity may be difficult to detect. This risk is present in the case of any unscrupulous taxpayer that uses elaborate or fraudulent schemes to

conceal such activity. Accordingly, referrals from internal and external sources are a component of TE/GE's robust compliance portfolio, that are, as TIGTA observes, "a valuable source of information, especially for the detection of fraudulent activity." Consistent with that conclusion, the data reflected in the report notes that while only 20 percent of the FY 2018 examination closures originated from referrals, they resulted in 40 percent of the total revocations of tax-exempt status for that year. TE/GE will continue to strive to balance the use of referrals with other compliance portfolios programs, such as data-driven methods and compliance strategies, to identify abuse and fraud.

TE/GE compliance strategies are a valuable tool to identify and prioritize compliance issues and allocate resources within the TE/GE filing population. Employees submit suggestions for development by CP&C and consideration and approval by the TE/GE Compliance Governance Board through a web-based portal. Submitters receive an acknowledgment thanking them for their submission and confirming that their submission was received and will be evaluated and considered. Current procedures in IRM 4.70.5.2.2.1(8) provide that "typically, no further feedback will be provided to protect work selection processes and procedures." This reflects that one of the goals and positive outcomes of CP&C has been the separation of classification, workload selection, and examination activities (see IRM 4.70.5.1.5(2)), which reduces potential and perceived conflict of interest in the identification and selection of examination workload. However, TE/GE shares TIGTA's goal of encouraging employees to submit potential compliance issues that may improve future workload selection, and so will seek to provide additional feedback to submitters, while taking into account internal controls for separation of duties.

Finally, TIGTA also observes in the report that annual information return filing exceptions and restrictive procedural requirements applicable to churches and certain other religious organizations create challenges in detecting noncompliance among these organizations. TE/GE administers the tax laws in effect, and seeks to promote compliance among all tax-exempt organizations, while appropriately taking into account the statutory filing exceptions in Section 6033 of the Internal Revenue Code (I.R.C.) and special procedural rules in Section 7611 of the I.R.C. put into place by Congress with respect to churches.

We appreciate the opportunity to review and comment on the draft report. Attached is a detailed response to your recommendation. If you have any questions, you or your staff may contact me at (202) 317-6449 or Stephen Martin, Acting Director, Exempt Organizations and Government Entities, at (513) 975-6646.

Attachment

Attachment

**Corrective Actions for TIGTA Audit Draft Report –  
Obstacles Exist in Detecting Noncompliance of Tax-Exempt Organizations  
(Audit # 201910021)**

**RECOMMENDATION 1:**

The Director, CP&C, should provide feedback to examiners who have submitted issues through the online submissions portal, without violating internal control separation of duties for examination selection.

**CORRECTIVE ACTION:**

We will develop a process to provide feedback to examiners who have submitted issues through the online submissions portal, without violating internal control separation of duties for examination selection.

**IMPLEMENTATION DATE:**

October 31, 2021

**RESPONSIBLE OFFICIAL(S):**

Director, Compliance, Planning & Classification, TE/GE

**CORRECTIVE ACTION MONITORING PLAN:**

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

**Abbreviations**

CP&C	Compliance Planning and Classification
EO	Exempt Organizations
FY	Fiscal Year
IRS	Internal Revenue Service
TE/GE	Tax Exempt and Government Entities
TIGTA	Treasury Inspector General for Tax Administration



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**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.