



Report to the Ranking Member,  
Committee on Homeland Security and  
Governmental Affairs, U.S. Senate

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December 2014

# TAX-EXEMPT ORGANIZATIONS

Better Compliance  
Indicators and Data,  
and More  
Collaboration with  
State Regulators  
Would Strengthen  
Oversight of  
Charitable  
Organizations

# GAO Highlights

Highlights of [GAO-15-164](#), a report to the Ranking Member, Committee on Homeland Security and Governmental Affairs, U.S. Senate

## Why GAO Did This Study

IRS oversight of charitable organizations helps to ensure they abide by the purposes that justify their tax exemption and protects the sector from potential abuses and loss of confidence by the donor community. In recent years, reductions in IRS's budget have raised concerns about the adequacy of IRS oversight.

GAO was asked to review IRS oversight of charitable organizations. In this report, GAO (1) describes the charitable organization sector, (2) describes IRS oversight activities, (3) determines how IRS assesses its oversight efforts, and (4) determines how IRS collaborates with state charity regulators and U.S. Attorneys to identify and prosecute organizations suspected of engaging in fraudulent (or other criminal) activity.

GAO reviewed and analyzed IRS data, strategic planning and performance documents, and documented improvement efforts. We also interviewed IRS and Department of Justice officials, state charity regulators, and subject matter specialists. GAO compared IRS's practices to federal guidance on performance management.

## What GAO Recommends

GAO recommends IRS 1) develop compliance goals and additional performance measures that can be used to assess the impact of enforcement activities on compliance and 2) clearly communicate with state charity regulators how they are allowed to use IRS information related to examinations of charitable organizations. GAO also recommends that Congress consider expanding the mandate for 501(c)(3) organizations to electronically file their tax returns to cover a greater share of filed returns. In written comments, IRS agreed with GAO's recommendations.

View [GAO-15-164](#). For more information, contact James R. McTigue, Jr. at (202) 512-9110 or [mctiguej@gao.gov](mailto:mctiguej@gao.gov).

December 2014

## TAX-EXEMPT ORGANIZATIONS

### Better Compliance Indicators and Data, and More Collaboration with State Regulators Would Strengthen Oversight of Charitable Organizations

## What GAO Found



Source: PhotoDisc, Ingram (photos). | GAO-15-164

Charitable organizations play a major role in our economy and provide critical services and resources to families and individuals in need. Although charitable organizations vary considerably in size and purpose, in 2011 the largest number of organizations was in the human services sector, providing services such as employment and housing assistance. The highest concentration of assets was in the health and education sectors, which include hospitals and universities. In addition to being concentrated in a few sectors, a large proportion of all assets were controlled by a relatively small number of charitable organizations—less than 3 percent hold more than 80 percent of the assets.

Over the past several years, as the Internal Revenue Service (IRS) budget has declined, the number of full-time equivalents (FTEs) within its Exempt Organizations (EO) division has fallen, leading to a steady decrease in the number of charitable organizations examined. In 2011, the examination rate was 0.81 percent; in 2013, it fell to 0.71 percent. This rate is lower than the exam rate for other types of taxpayers, such as individuals (1.0 percent) and corporations (1.4 percent).

EO is grappling with several challenges that complicate oversight efforts. While EO has some compliance information, such as how often exams result in change of tax exempt status, it does not have quantitative measures of compliance for the charitable sector as a whole, for specific segments of the sector (such as universities and hospitals) or for particular aspects of noncompliance (such as personal inurement or political activity). Because EO does not have these measures and does not know the current level of compliance, it cannot set quantitative, results-oriented goals for increasing compliance or assess to what extent its actions are affecting compliance.

Statutory requirements for safeguarding taxpayer data limit both IRS's ability to share data and state regulators' ability to use it. A lack of clarity about how state regulators are allowed to use IRS data to build cases against suspect charitable organizations further impedes regulators' ability to leverage IRS's examination work.

The e-filing rate for tax-exempt organizations is significantly lower than for other taxpayers. This lower rate means there is less digitized data available for data analytics and higher labor costs for IRS. Expanded e-filing may result in more accurate and complete data becoming available in a timelier manner, which in turn, would allow IRS to more easily identify areas of noncompliance.

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## Abbreviations

ACT	Advisory Committee on Tax Exempt and Government Entities
DOJ	Department of Justice
EO	Exempt Organizations
FTE	full-time equivalent
GDP	gross domestic product
GPRA	Government Performance and Results Act of 1993
IRC	Internal Revenue Code
IRS	Internal Revenue Service
MOU	memorandum of understanding
NAAG	National Association of Attorneys General
NASCO	National Association of State Charity Officials
NRP	National Research Program
PPA	Pension Protection Act of 2006
RICS	Return Inventory Classification System
SOI	Statistics of Income
TIGTA	Treasury Inspector General for Tax Administration
Treasury	Department of the Treasury

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December 17, 2014

The Honorable Tom Coburn, M.D.  
Ranking Member  
Committee on Homeland Security and Governmental Affairs  
United States Senate

Dear Dr. Coburn:

The breadth and diversity of the tax-exempt sector, which encompasses over 1.6 million entities, including 501(c)(3) charitable organizations, allows it to address a wide range of needs, including comfort to the aging, and food, shelter and other services for families and individuals in need.<sup>1</sup> Moreover, the tax-exempt sector represents an estimated 5 percent of gross domestic product and is concentrated in two key sectors of the economy, with the largest assets in healthcare and education. The Internal Revenue Service (IRS), along with the states, has a vital role in overseeing the tax-exempt sector. IRS oversight can help ensure that exempt entities abide by the purposes that justify their tax exemption. IRS can also help protect the sector from potential abuses and loss of confidence by the donor community that could result from the abusive activities of a small minority of charitable organizations.

IRS—which oversees charitable organizations’ compliance with the tax code—has experienced budget cuts over the past several years. As we previously reported, the IRS budget has declined by about \$900 million since fiscal year 2010 and funding is below fiscal year 2009 levels.<sup>2</sup> Staffing has also declined by about 10,000 full-time equivalents (FTE) since fiscal year 2010, and performance has been uneven. Questions

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<sup>1</sup>For the purposes of this report, charitable organizations are those organizations which are tax exempt with regard to their charitable activities under section 501(c)(3) of the Internal Revenue Code (IRC). Charitable organizations are “corporations, and any community chest, fund, or foundations, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals.”

<sup>2</sup>GAO, *IRS 2015 Budget: Long-Term Strategy and Return on Investment Data Needed to Better Manage Budget Uncertainty and Set Priorities*, [GAO-14-605](#) (Washington, D.C.: June 12, 2014).

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about the impact of budget cuts on IRS's operations have raised concerns about the adequacy of oversight of charitable organizations.

You asked us to review a number of issues related to the IRS oversight of charitable organizations. This report (1) describes what is known about the number, type, size, and other characteristics of charitable organizations; (2) describes IRS oversight activities for charitable organizations; (3) determines how IRS assesses its oversight efforts of charitable organizations to ensure they are meeting their charitable purposes; and (4) determines how IRS collaborates with state charity regulators and U.S. Attorneys to identify and prosecute organizations suspected of engaging in fraudulent or other criminal activity.

To address the first objective, we reviewed IRS documentation and analyzed data from IRS's Statistics of Income (SOI) samples of tax-exempt organization information returns for tax year 2011, the most recent year available.<sup>3</sup> We used data from the charitable organizations that filed Forms 990 and 990-EZ (which provide information on the filing organization's mission, programs, and finances). We do not report data on private foundations (which are charitable organizations that file Form 990-PF) or report data on Form 990-N filers, because the data for these organizations is less complete and has other limitations. In addition, our data excludes certain religious organizations, which qualify as 501(c)(3) organizations, but are not required to file a return. The SOI samples were based on returns as filed, and did not reflect IRS audit results. The data that we report are estimates based on the SOI sample; statements about sampling errors are reported in appendix III.

For the second objective, we reviewed IRS documentation and obtained IRS data on IRS oversight activities including referrals and examinations performed on charitable organizations, and reviewed data on charitable organizations that had their tax-exempt statuses revoked for fiscal years 2011 through 2013. We also interviewed IRS officials about their oversight activities.

To assess the reliability of the data we analyzed, we reviewed IRS documentation and interviewed agency officials familiar with the data. We

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<sup>3</sup>SOI data from years prior to 2011 are not included in this report because the reporting thresholds varied so much in these years that year-to-year comparisons of the data would be difficult to interpret.

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determined that these data were sufficiently reliable for the purposes of this report.

For the third objective, we reviewed relevant strategic and performance documents and interviewed IRS planning officials and division managers to determine the extent to which managers overseeing the tax-exempt sector do the following: set performance goals, develop measures to monitor their progress toward meeting goals, and use data both to identify challenges and their causes, and to develop strategies to address those challenges. We reviewed past recommendations made by the Treasury Inspector General for Tax Administration (TIGTA) and the National Taxpayer Advocate related to performance management and interviewed IRS managers about how they addressed the issues discussed in those reports. For criteria, we compared IRS information on performance measures and decision making to *Standards for Internal Control in the Federal Government* and federal guidance on performance management.<sup>4</sup> We also applied the criteria concerning the administration, compliance burden, and transparency that characterize a good tax system, as developed in our guide for evaluating tax reform proposals.<sup>5</sup>

To determine how IRS collaborates with state charity regulators and U.S. Attorneys, we reviewed various IRS documents and interviewed IRS and Department of Justice (DOJ) officials, and representatives from National Association of State Charity Officials (NASCO). For criteria, we identified different approaches for sharing information and collaboration, based on our audit findings, as well as our past recommendations and recommendations made by the Advisory Committee on Tax Exempt and Government Entities (ACT).<sup>6</sup>

To provide additional context for all three objectives, we interviewed IRS officials, DOJ officials, state charity regulators, subject matter specialists,

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<sup>4</sup>GAO, *Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (Washington, D.C.: November 1, 1999).

<sup>5</sup>GAO, *Understanding the Tax Reform Debate: Background, Criteria, & Questions*, [GAO-05-1009SP](#) (Washington, D.C.: Sept. 1, 2005).

<sup>6</sup>GAO, *Tax-Exempt Sector: Governance, Transparency, and Oversight are Critical for Maintaining Public Trust*, [GAO-05-561T](#) (Washington, D.C.: April 20, 2005); GAO, *Tax-Exempt Organizations: Improvements Possible in Public, IRS, and State Oversight of Charities*, [GAO-02-526](#) (Washington, D.C.: April 30, 2002).



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and stakeholder groups representing different types of exempt-organizations and private watchdog organizations that oversee charities about the following: the adequacy of IRS oversight of charitable organizations, the challenges IRS faces providing effective oversight, and strategies to address those challenges.

We conducted this performance audit from June 2014 to December 2014 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. More detailed information on our scope and methodology appears in appendix I.

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## Background

Section 501 of the Internal Revenue Code (IRC) provides for tax exemption for certain corporations, trusts, and other organizations. Section 501(c) establishes 29 categories of tax-exempt organizations, ranging from cemeteries to professional football leagues—see appendix II for complete list of different types of tax-exempt-organizations, as well as more detailed information on the tax treatment for these organizations. The largest number of such organizations falls under section 501(c)(3), which recognizes charitable organizations. Generally, while charitable organizations pay no income taxes on contributions received, these entities can be taxed on income generated from business activities that are unrelated to their charitable purposes. These charitable organizations and related parties may be subject to several additional IRS penalties and fines for certain actions, such as not filing a required tax return. Generally, taxpayers who itemize their deductions may deduct the amount of any contribution to charitable organizations from their taxable income.

The IRC requires that an organization adhere to certain accepted charitable, religious, educational, scientific, or literary purposes to qualify for 501(c)(3) tax-exempt status.<sup>7</sup> The IRC also prohibits charitable organizations from undertaking certain activities: no earnings of the organization may benefit individual or private shareholders, no substantial attempt may be made to spread propaganda or influence legislation, and

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<sup>7</sup>See appendix II for a full list of accepted charitable purposes for 501(c)(3) organizations.

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no effort may be made to campaign for or against a candidate for public office.<sup>8</sup> In order to receive 501(c)(3) tax-exempt status, an organization must submit a Form 1023 or Form 1023-EZ and organizing documents to IRS to describe its charitable purpose and financial data.<sup>9</sup> The organizing documents can include articles of incorporation or by-laws governing the activities and charitable purpose of the entity. Submitting an application is one of the first interactions a tax-exempt organization will have with IRS.<sup>10</sup> The organization will then receive a determination letter from IRS which informs the organization whether its application for tax-exempt status has been approved or denied. Alternatively, the organization may be told the IRS is in need of additional information in order to make a determination.

If an organization is successful in receiving tax-exempt status, it will continue to interact with IRS on an annual basis by submitting an information return or an electronic notice.<sup>11</sup> The form contains information on the organization's mission, programs, finances and governance structure which helps IRS to determine whether the organization is meeting its charitable purpose and therefore is eligible for tax-exempt status. Certain organizations that have gross receipts of \$50,000 per year or less may submit the Form 990-N—an abbreviated electronic version of the Form 990 return, often called the e-Postcard. The Form 990-EZ is less abbreviated, though still more streamlined than the Form 990, and

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<sup>8</sup>26 U.S.C. § 501(c)(3); 26 C.F.R. § 1.501(c)(3).

<sup>9</sup>*Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*. Charities that meet certain requirements and have gross receipts of \$50,000 or less and assets of \$250,000 or less, may submit the 1023-EZ, an abbreviated version of the original form.

<sup>10</sup>This excludes certain religious organizations, such as churches and their auxiliaries and associations, which are recognized as tax exempt, but need not apply for tax exempt status.

<sup>11</sup>IRS Form 990, *Return of Organization Exempt from Income Tax*.

may be used by certain entities with gross receipts under \$200,000 and assets under \$500,000. Private foundations complete the 990-PF.<sup>12</sup>

**Table 1: Information Returns Filed by 501(c)(3) Tax-Exempt Organizations**

Form	Description	Threshold
990	The Form 990 is an information return submitted to IRS by organizations exempt from income tax. This form includes information on an entity's mission, programs, finances, and corporate governance structure. Organizations that are required to submit the Form 990 must submit this form annually.	Gross receipts greater than or equal to \$200,000 or total assets greater than or equal to \$500,000.
990-EZ	A streamlined version of the Form 990, which may be used by entities with gross receipts under \$200,000 and assets under \$500,000. Organizations eligible to file a Form 990-EZ may choose to file the Form 990.	Gross receipts less than \$200,000 and total assets less than \$500,000.
990-N	Also called the e-Postcard, this is an abbreviated version of the Form 990 for entities with gross receipts of \$50,000 per year or less. This form is submitted electronically. Organizations eligible to file a Form 990-N may choose to file the Forms 990-EZ or 990.	Gross receipts normally less than or equal to \$50,000.
990-PF	This Form 990 is used by private foundations regardless of their financial status. Private foundations may not use other versions of the Form 990.	Regardless of financial status.

Source: GAO analysis of IRS forms. | GAO-15-164

IRS oversees charitable organizations through its Exempt Organizations (EO) Business Division (a part of IRS's Tax Exempt and Government Entities Division). EO's oversight relies primarily on two sets of activities: a front-end review of applications and a back-end review of a relatively small number of information and tax returns. At the front end, the EO Rulings and Agreements office reviews all applications for tax-exempt status. At the back end, EO Examinations analyzes the operations and finances of a small percentage of exempt organizations through examinations (audits). Exam agents propose tax assessments or changes to exempt status when necessary, as well as advise organizations about how to comply with the law in the future. Through

<sup>12</sup>Every organization that qualifies for tax exemption as an organization described in 501(c)(3) is a private foundation unless it falls into one of the categories specifically excluded from the private foundation definition. Organizations that fall into the excluded categories are institutions such as hospitals or universities and those that generally have broad public support or actively function in a supporting relationship to such organizations. When applying for charitable organization status, an applicant is presumed to be a private foundation unless it can demonstrate that it is not a private foundation. Private foundations are subject to certain tax consequences which do not apply to other charitable organizations. For more information on the tax treatment of private foundations, please see appendix II.

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these activities, IRS tries to ensure that charities merit the recognition of a tax-exempt status as well as the retention of it.<sup>13</sup>

IRS and state charity regulators both play a key role providing oversight of charitable organizations.<sup>14</sup> IRS's oversight interests are in ensuring that tax-exempt organizations comply with federal tax law. State charity regulators have a broader oversight interest which includes the application of state trust, non-profit corporation, consumer protection, and charitable solicitation laws. Although these federal and state regulators have distinct oversight interests, these interests are closely related and at times, overlapping. Both IRS and state charity regulators seek to prevent excess compensation, private inurement, conflicts of interest, and other abusive practices by charitable organizations. IRS also collaborates with U.S. Attorneys at the DOJ to identify and prosecute criminal tax violations. Although EO does not collaborate directly with DOJ, criminal investigations may be initiated within IRS at the recommendation of an IRS revenue agent who has detected potential criminal activity. Investigations may also be initiated at the advice of a U.S. Attorney's office, a law enforcement agency, or the public. IRS criminal investigations are led by an IRS special agent. If substantial evidence is found for a criminal case, then—after multiple rounds of supervisory review—the investigation may be referred to the DOJ Tax Division or the relevant U.S. Attorney's office. If DOJ or the U.S. Attorney accepts the investigation for prosecution, the case is then handled by the prosecutors.<sup>15</sup>

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<sup>13</sup>Until the fall of 2014, EO also included the Customer Education and Outreach unit, which attempted to improve compliance by developing and delivering programs and products designed to help charitable and other exempt organizations understand their tax responsibilities. This unit was moved to Shared Services.

<sup>14</sup>State charity regulators vary by state and include state attorneys general, secretaries of state, consumer protection and licensing bodies, a bureau of investigation, and similar entities.

<sup>15</sup>Internal Revenue Manual (IRM) 9.5.1 Administrative Investigations and General Investigative Procedures ([http://www.irs.gov/irm/part9/irm\\_09-005-001.html](http://www.irs.gov/irm/part9/irm_09-005-001.html) downloaded November 24, 2014).

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## Charitable Organizations Comprise a Major Part of Our Economy and Vary Considerably in Size and Purpose

Charitable organizations comprise a significant part of our economy in terms of their share of the gross domestic product (GDP) and their importance in services vital to the well being of citizens. Available estimates indicate that tax-exempt organizations serving households generate about 5 percent of U.S. GDP.<sup>16</sup> The federal government increasingly relies on these organizations to deliver critical services: in 2012, government agencies paid an estimated \$137 billion to nonprofit organizations in grants and contracts for services.<sup>17</sup> Also, for fiscal year 2013, the Department of the Treasury (Treasury) estimated the tax expenditure for deductions for contributions to charitable organizations totaled over \$48 billion.<sup>18</sup>

As shown in figure 1, the total population of nonprofit organizations can be broken down by tax-exempt status and by the requirement to file returns.<sup>19</sup> In 2012, an estimated 2.3 million nonprofit organizations operated in the United States, including organizations that have not applied for tax-exempt status with IRS.<sup>20</sup> Of nonprofits in 2011, 1.63

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<sup>16</sup>Gross domestic product is the market value of all goods and services produced within a country during a given time period. See Brice S. McKeever and Sarah L. Pettijohn, *The Nonprofit Sector in Brief 2014* (Washington D.C.: Urban Institute, October 2014); and Molly F. Sherlock and Jane G. Gravelle, *An Overview of the Nonprofit and Charitable Sector*, CRS-R40919 (Washington, D.C.: Congressional Research Service, Nov. 17, 2009).

<sup>17</sup>See Sarah L. Pettijohn, Elizabeth T. Boris, Carol J. De Vita, and Saunji D. Fyffe, *Nonprofit-Government Contracts and Grants: Findings from the 2013 National Survey* (Washington D.C.: Urban Institute, December 2013).

<sup>18</sup>Tax expenditure estimates do not incorporate any behavioral responses and thus do not represent the amount of revenue that would necessarily be gained if the tax expenditure was repealed. Changes in taxpayer behavior are taken into account when Treasury prepares revenue estimates for proposed legislation.

<sup>19</sup>According to the Congressional Research Service (CRS), the term 'nonprofit organization' refers to "an entity that is not intended to be a profit-making corporation. The term can be more precisely understood to mean an entity organized under the laws of a state, with its status and privileges determined under state law. Because the qualifications for nonprofit status vary among states, it is possible for the term 'nonprofit organization' to be broader than, narrower than, or identical to the term 'tax-exempt' organization. For a nonprofit organization to be exempt from federal income taxes, it must meet the statutory requirements found in the Internal Revenue Code and usually must file an application with IRS. Some organizations, including small 501(c)(3) organizations and qualifying religious organizations, are exempt from the application requirement." See Sherlock and Gravelle, *An Overview of the Nonprofit and Charitable Sector*.

<sup>20</sup>See Katie L. Roeger, Amy S. Blackwood, and Sarah L. Pettijohn, *The Nonprofit Almanac 2012* (Washington D.C.: Urban Institute Press, 2012).

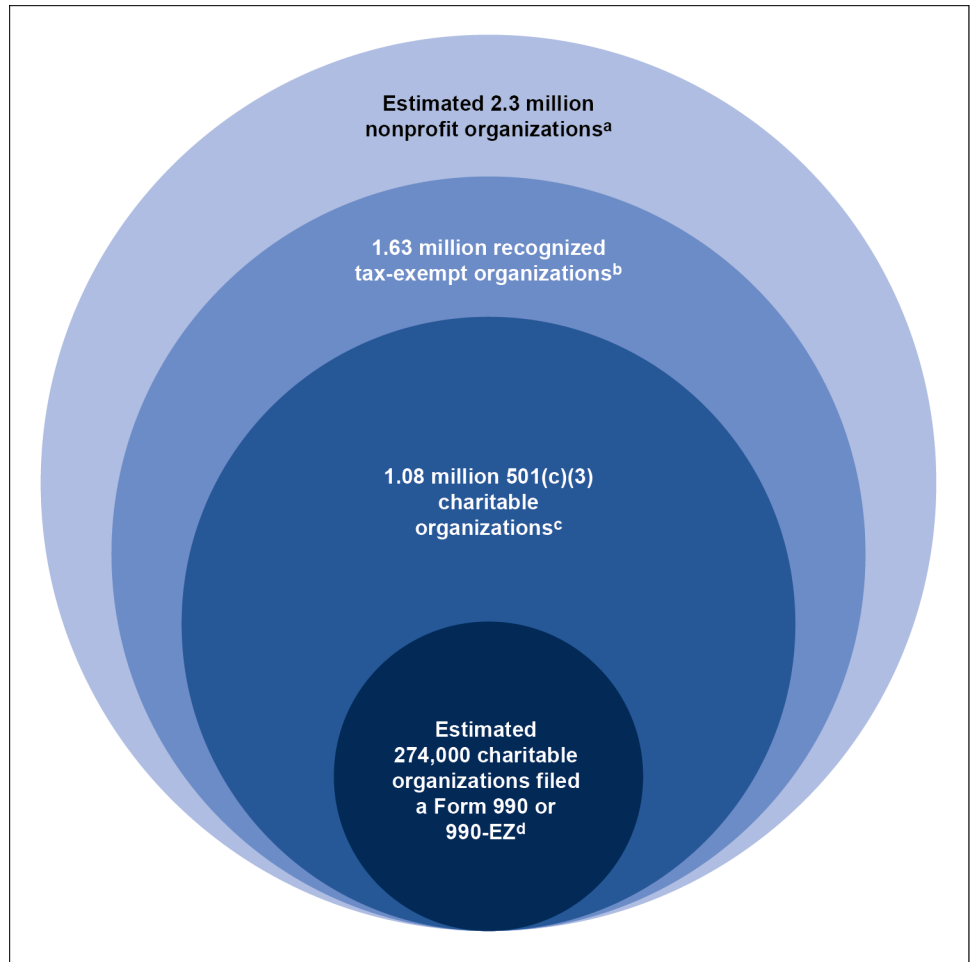
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million had been recognized as tax-exempt by IRS and 1.08 million of them were 501(c)(3) charitable organizations.<sup>21</sup> An estimated 274,000 of these charitable organizations filed returns—around 189,000 filed Form 990 and 85,000 filed Form 990-EZ.

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<sup>21</sup>Tax-exempt organizations are organizations that have received tax-exempt status from the IRS under Internal Revenue Code sections 501(c)-exempt organizations, 501(d)-religious and apostolic associations, 501(e)-cooperative hospital service organizations, 501(f)-cooperative service organizations of operating educational organizations, 501(k)-child care organizations, 501(n)-charitable risk pools, 527-political organizations, and nonexempt charitable trusts and split-interest trusts. For more information about other types of tax exempt entities, see appendix II.

**Figure 1: The Universe of Nonprofit Organizations**



Source: GAO analysis. | GAO-15-164

<sup>a</sup>This is an estimate of the total number of nonprofit organizations in the United States, including those that have not applied for or received tax-exempt status from IRS. This data is from Urban Institute's *The Nonprofit Almanac 2012*. The almanac did not have 2011 data for the universe of estimated nonprofit organizations, but we would not expect the number to vary greatly between 2011 and 2012.

<sup>b</sup>This includes all organizations that have been recognized as tax-exempt by IRS. The data is from the *IRS Data Book 2011*.<sup>22</sup>

<sup>22</sup>IRS, *Data Book, 2011*, Publication 55B (Washington, D.C.: March 2012).

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<sup>c</sup>This includes all organizations that are tax-exempt 501(c)(3) charitable organizations. The data is from the *IRS Data Book 2011*.

<sup>d</sup>This is an estimate of all 501(c)(3) charitable organizations that filed Forms 990 or 990-EZ. This figure excludes other types of tax-exempt entities that may have filed these forms. This also excludes 501(c)(3) charitable organizations that filed Forms 990-N or 990-PF, or a different type of return. This is a GAO analysis of SOI data for tax year 2011.

As shown in figure 2, the number of charitable organizations that were recognized as tax-exempt by IRS increased from more than 960,000 in 2003 to more than 1.28 million in 2010 (a 33 percent increase) but declined to 1.05 million in 2013 (a 18 percent decrease from 2010). After 2010, this decline was primarily due to the Pension Protection Act of 2006 (PPA), which mandated that any organization—large or small—that failed to file a required return or notice for three consecutive years would automatically lose its federal tax exemption.<sup>23</sup> Since PPA's passage, more than 570,000 organizations have lost their tax-exempt status through the automatic revocation process.<sup>24</sup> The net effect on the number of charitable organizations (when new applicants and reinstated revocations are included) is an average decline of about 200,000 from the peak in 2010.

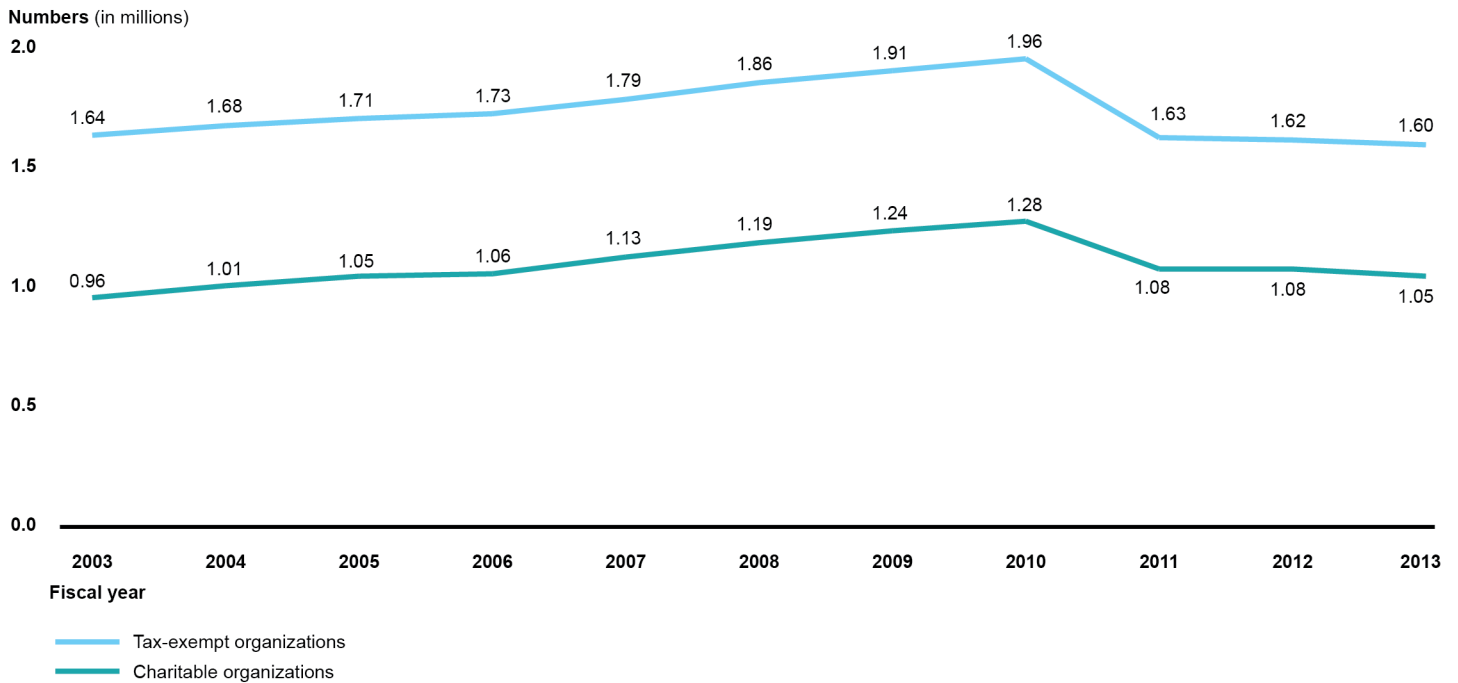
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<sup>23</sup>Pub. L. 109-280, § 1223(b), 120 Stat. 780, 1090–1091 (2006) (*codified at* 26 U.S.C. § 6033(j)).

<sup>24</sup>See Matthew R. Madara, *IRS Working to Clear Exempt Organization Application Backlog*, Tax Notes Today (Aug. 20, 2014). Charitable organizations that have had their tax-exempt status automatically revoked must file Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code* to have their tax-exempt status reinstated, even if the organization was not originally required to file the form. Certain charitable organizations can file for reinstatement using Form 1023-EZ, *Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*.



**Figure 2: Number of Tax-Exempt and Charitable Organizations That Were Recognized As Tax-Exempt from IRS, Fiscal Years 2003-2013**



Source: IRS Data Books. | GAO-15-164

Note: Includes private foundations. For fiscal year 2013, cooperative hospital service organizations, cooperative service organizations of operating educational organizations, child care organizations, and charitable risk pools were reported with section 501(c)(3) charitable organizations.

### Although Charitable Organizations Vary in Size and Purpose, a Small Number Concentrated in the Health and Education Sectors Control Most Assets

Charitable organizations, excluding private foundations, represent a diverse array of mission areas and range greatly in asset size, the amount of revenue they raise, and their expenses. As shown in figure 3, the largest number of charitable organizations filing Forms 990 and 990-EZ were in the human services sector. However, the health and education sectors had the largest amount of assets.

**Interactive graphic**

**Figure 3: Number of Charitable Organization Filers by Mission Category, Tax Year 2011**



**Directions:**  
 Mouseover total asset bars from each mission area category for additional financial information

	Number	Total assets (in millions)
Arts, culture, and humanities	27,107	\$106,969
Education	47,928	\$1,023,648
Environment and animals	11,763	\$42,837
Health	35,267	\$1,238,533
Human services	105,444	\$323,735
International and foreign affairs	5,744	\$32,048
Public and social benefit	24,718	\$218,573
Religion-related	15,628	\$25,217
Mutual and membership benefit	687	\$18,557

Sources: GAO analysis of SOI data from IRS Form 990 and IRS Form 990-EZ; PhotoDisc (images). | GAO-15-164

Note: Statements about sampling errors are reported in appendix III.

**Print instructions** | To print a text version of this graphic, go to appendix III, tables 6 and 7.

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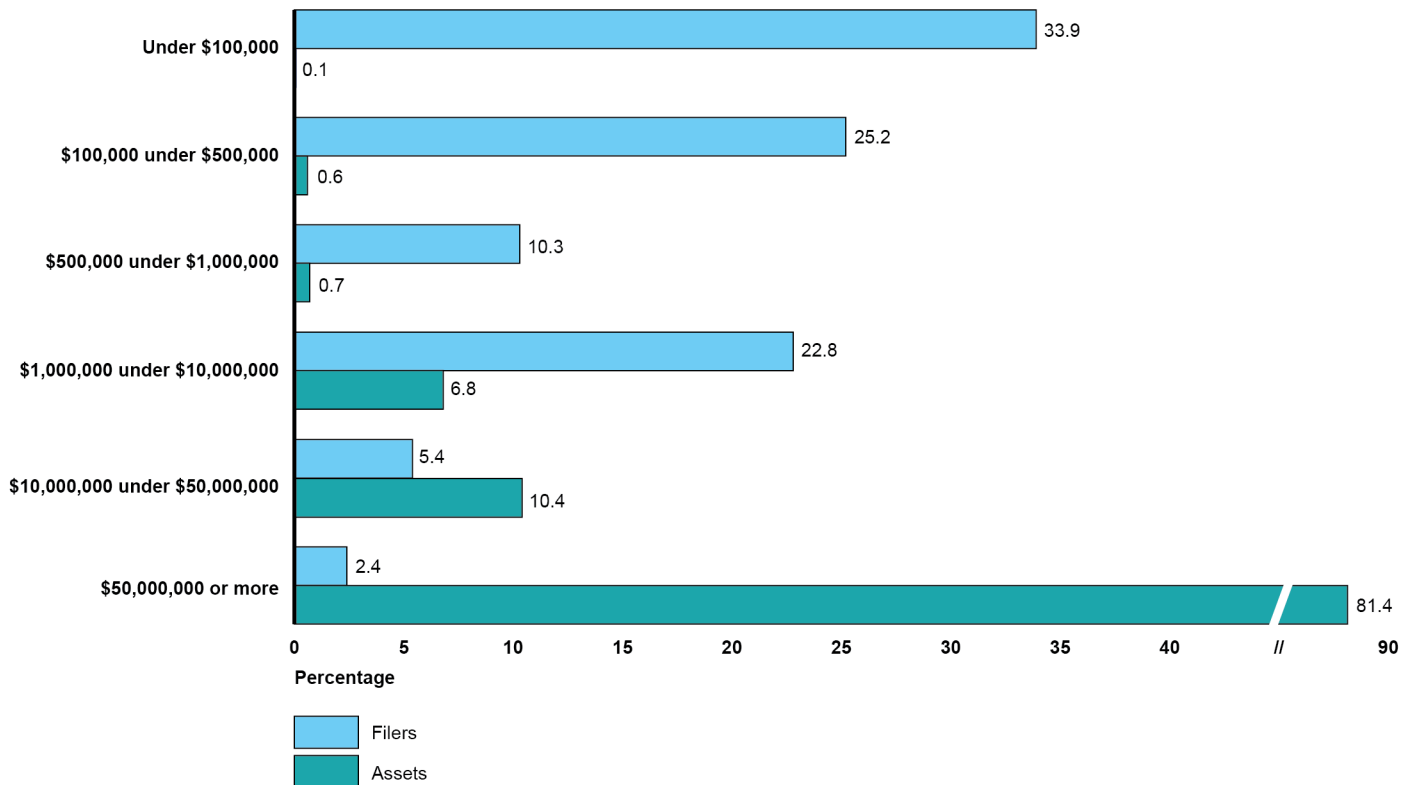
The human services sector represents 38 percent of the total population of charitable organizations that file Form 990 or 990-EZ returns, followed by the education sector at 18 percent and the health sector at 13 percent. For more information by mission category, see appendix III. All three sectors cover a diverse range of programs and serve different segments of the population. The human services sector includes activities related to employment, housing and shelter, and youth development. Education includes elementary, secondary, vocational, and technical schools and universities. Health includes hospitals, mental health and crisis intervention, and medical research.

The assets of charitable organizations that file Forms 990 or 990-EZ returns are concentrated in the health and education sectors, which held about 75 percent of the total assets—more than \$2 trillion—while the human services sector held almost \$324 billion (or about 11 percent) of the total. In addition to being concentrated in a few sectors, a large proportion of total assets were controlled by a relatively small number of charitable organizations. Of the charitable organizations that file a Form 990 or Form 990-EZ, less than 3 percent held more than 80 percent of the assets, as shown in figure 4.<sup>25</sup> These organizations were primarily from the health and education sectors. Over 59 percent of charitable organizations that file Forms 990 or 990-EZ returns (with less than \$500,000 in assets) held less than 1 percent of all assets.

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<sup>25</sup>Figure 4 does not include private foundations, or Form 990-N filers—which are smaller charitable organizations in terms of assets.

**Figure 4: Percentage of Charitable Organization Filers and Assets by Asset Category, Tax Year 2011**



Source: GAO analysis of SOI data from Forms 990 and 990-EZ. | GAO-15-164.

Note: Statements about sampling errors are reported in appendix III.

Most of the expenses of charitable organizations that filed Form 990 were for program services, which are mainly activities that further the organization’s tax-exempt purposes. Total expenses of charitable organizations are broken down on the Form 990 into program service expenses, management and general expenses, and fundraising expenses.<sup>26</sup> About eighty-seven percent of Form 990 charitable organization expenses in 2011 were for program services, about 12 percent for general management, and about 1 percent for fundraising. As we noted in our 2002 report, charitable organizations have discretion in

<sup>26</sup>Although the Form 990-EZ shows the amount of expenses by charitable organizations, it does not break out expenses into this group of categories.

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determining how to charge and allocate expenses for program services, general management, and fundraising.<sup>27</sup> The differences in methods can result in charities with similar activities allocating expenses differently among expense categories. This complicates interpretation of these data. For more information on expenses, see appendix III.

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## EO Receives Indications of Noncompliance from a Variety of Sources, but Declining Resources Complicate Efforts to Effectively Oversee Charitable Organizations

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### EO Receives Indications of Noncompliance from a Variety of Sources

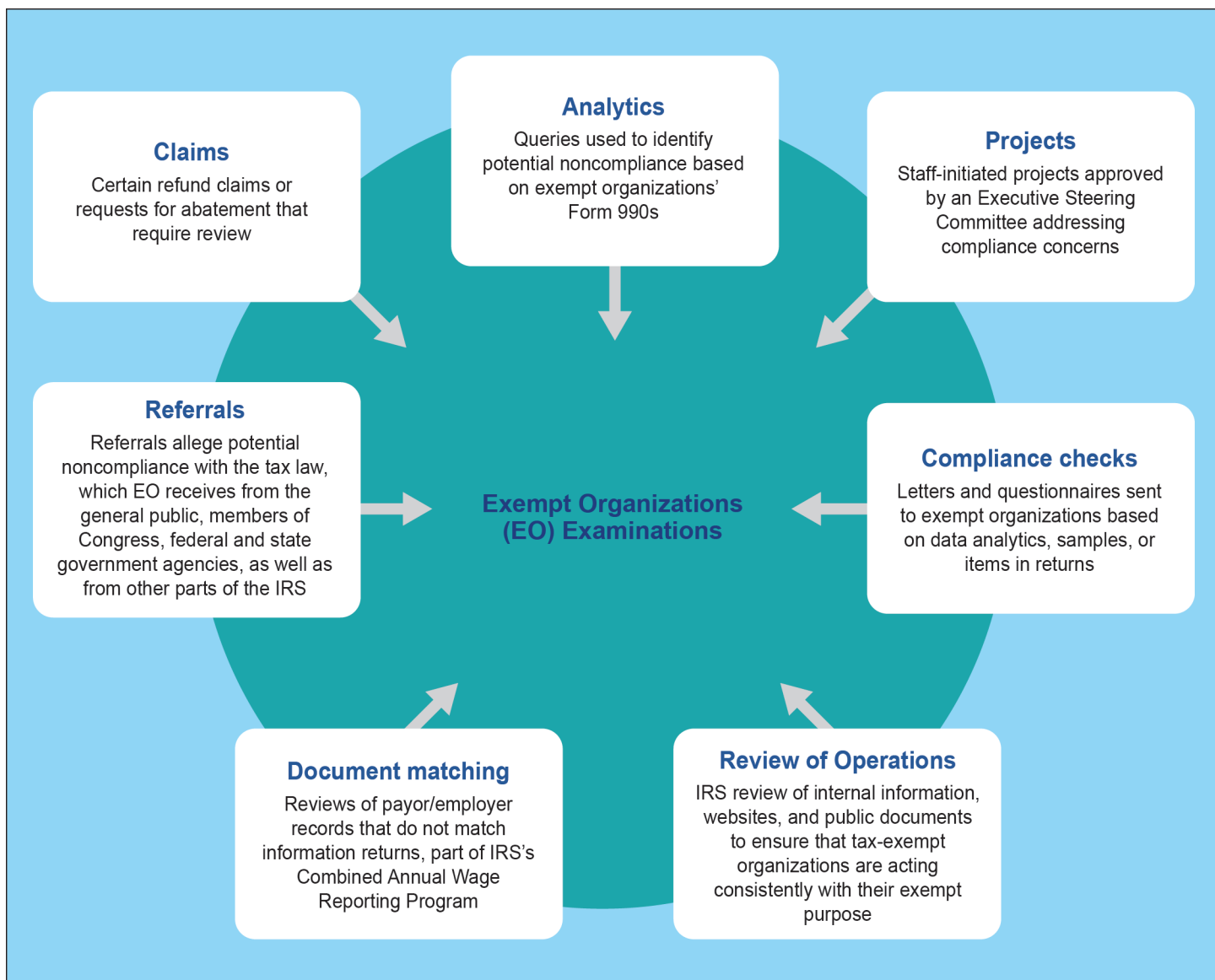
Through its examinations, IRS can analyze the operations and finances of tax-exempt organizations and propose tax assessments or changes to exempt status when necessary. In general, IRS attempts to select entities that it believes are likely to have violated requirements, such as unauthorized use of an organization's assets, or engaging in political activity. On the basis of these examinations, IRS can accept the Form 990 as filed or can change the status of the entity, impose excise taxes for certain types of violations, or revoke the tax-exempt status if the violations are serious enough. It can also assess taxes if an entity has not fully paid employment taxes or taxes on unrelated business income. IRS can also advise organizations on complying with the law in the future. This can include sending written advisories to organizations advising them of specific issues that need to be addressed.

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<sup>27</sup> [GAO-02-526](#).

IRS receives indications of noncompliance from a variety of sources that can lead to examinations, as shown in figure 5.

**Figure 5: Sources of Charitable Organization Examinations in 2013**



Source: GAO analysis of IRS documents. | GAO-15-164

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EO initiated 8,413 exams of tax-exempt organization returns in 2013 and 4,495 of these (or about 53 percent) were exams of charitable organizations. As shown in table 2, the largest source for these exams (41 percent) was the category that includes the IRS National Research Program project. EO participated in an IRS National Research Program project on employment taxes in 2013, which contributed to an unusually high number of exams during that year.

The next largest source (22 percent) was Form 990 data analytics. In 2008, IRS redesigned the Form 990 for the purposes of promoting compliance and increasing transparency. The redesigned form requires filing organizations to supply more in-depth information than previous versions. For example, the form includes new questions on governance, compensation, activities, relationships with related organizations, international activities, fundraising, non-cash contributions, and other compliance areas. A team of EO specialists developed data-mining queries (based on the redesigned form) to identify suspected inaccuracies or anomalies. For example, with the new Form 990, EO can search for whether an organization reports that it has a mortgage and receives rental income—suggesting that it has unrelated business income. If the organization does not file a Form 990-T, Exempt Organization Business Income Tax Return to report any unrelated business income, IRS is more likely to select the organization for examination. As of April 2014, EO had developed a list of over 150 condition codes based on return line entries to identify potential noncompliance issues.

Of the charitable organization examinations initiated in fiscal year 2013, 632 (or 14 percent) were the result of referrals (including news items)—communication EO receives from internal and external sources alleging potential noncompliance with the tax law. EO managers told us referrals are prioritized so that those involving a serious breach of public trust or abuse—such as financial investigations or allegations of terrorism—are to be examined right away. On the other hand, high profile referrals—referrals resulting from a media exposé or involving a well-known organization—are not necessarily high priority, and may not be examined right away. The two most common sources of referrals for all tax-exempt organizations in 2013 were the general public, with about 81 percent of the 6,940 total referrals, and other IRS functional areas, with about 12 percent of the total. The specific potential violations most commonly

alleged were that income or assets were being used for private benefit, the organization was involved in a political campaign; or the organization failed to report employment, income, or excise tax liability properly.<sup>28</sup>

**Table 2: Source of Charitable Organization Examinations Initiated, Fiscal Year 2013**

Source	Number of examinations initiated	Percent of examinations initiated
IRS National Research Program project on employment taxes and other <sup>a</sup>	1,851	41.2
Form 990 data analytics	994	22.1
Document matching	444	9.9
Referral received from outside IRS	361	8.0
Referral received from inside IRS	255	5.7
Review of Operations	178	4.0
Refund claims or requests for abatement	145	3.2
Compliance checks – letters	131	2.9
Compliance checks – questionnaires	120	2.7
News items <sup>b</sup>	16	0.4
<b>Total</b>	<b>4,495</b>	<b>100.0</b>

Source: IRS's Return Inventory Classification System. | GAO-15-164

<sup>a</sup>Includes instances where a return was added during an examination—either the same return from a different year or a different return.

<sup>b</sup>Includes referrals IRS received in the form of submitted news clippings; does not include referrals received from members of the media, which IRS groups with referrals received from the general public.

## Limited Resources Contribute to Fewer Examinations

With IRS budget cuts, the number of EO FTEs has declined over the past several years, leading to a steady decrease in the number of organizations examined. The total number of FTEs in the EO division decreased from 889 to 842 (about 5 percent) and the number of FTEs doing examinations declined from 529 to 493 (about 7 percent) between fiscal years 2010 and 2013, as shown in table 3.

<sup>28</sup>These figures represent sources and potential violations for tax-exempt organizations. The figures could not be broken out separately for charitable organizations because of limitations in the EO data. However, because charitable organizations are a significant portion of tax-exempt organizations (about 66 percent), we expect the relative proportions to be similar for the charitable organizations.



**Table 3: Number of FTEs in IRS Exempt Organization Division by Function, Fiscal Years 2010-2013**

Fiscal year	Rulings and Agreements	Examinations <sup>a</sup>	Customer Education and Outreach	Director's Office/Program Management <sup>b</sup>	Total
2010	341	529	9	10	889
2011	328	534	12	12	886
2012	319	516	11	12	858
2013	326	493	11	12	842

Source: IRS officials. | GAO-15-164

<sup>a</sup>Not all employees perform examinations.

<sup>b</sup>Supports the Director, EO and all of EO's functional areas, tracks EO's budget, monitors hiring and promotions, measures and reports EO's performance and performance goals internally, and helps ensure that EO is responsive to the needs of the headquarters Tax-Exempt and Government Entities Division, and the Commissioner.

IRS examines only a small percentage of charitable organizations that file returns, including private foundations, as shown in table 4.<sup>29</sup> EO examination rates were lower, relative to other IRS divisions. For charitable organizations, the examination rate was about 0.7 percent in 2013, while for individual and corporate tax returns it was 1 percent and 1.4 percent, respectively.<sup>30</sup> A comparison of tables 3 and 4 also shows that the number of employees performing exams has declined while the number of returns filed has increased. From fiscal year 2011 to 2013, the exam rate decreased from .81 percent to .71 percent (by about 12 percent).

**Table 4: Examination Rate of Charitable Organizations, Fiscal Years 2011-2013**

Fiscal year	Returns filed in previous year	Returns examined in fiscal year	Examination rate
2011	725,888	5,888	0.81%
2012	753,985	5,864	0.78%
2013	763,149	5,426	0.71%

Source: IRS's Return Inventory Classification System and IRS officials. | GAO-15-164

<sup>29</sup>Individual charitable organizations may file information returns, such as the Form 990 and Form 990-EZ. They may also file tax returns—such as the Form 990-T—for unrelated business income and Form 941 for employment taxes.

<sup>30</sup>Corporate tax returns exclude Form 1120S, *U.S. Income Tax Return for an S Corporation*.

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As shown in table 5, examinations may result in no change to the amount of taxes owed or the tax-exempt status, the assessment of taxes or penalties, or the revocation of tax-exempt status. The no-change rate over the past three years has been between 30 and 34 percent. According to EO officials, IRS uses change and no-change rates as one indicator of how well it is targeting exams. Therefore higher no-change rates indicate that IRS is spending resources examining compliant entities. The 30 percent no-change rate for charitable organizations is relatively high when compared to the rate for some other filers. For example, in 2013, the no-change rate for all examinations of individual tax returns ranged from 9 to 12 percent, depending on the type of exam that was conducted.

An organization may be subject to a tax assessment or penalty charges for filing a late return, for failure to provide required document, or for late payment of taxes. IRS can also revoke tax-exempt status when charitable organizations (or individuals responsible for the organization) violate certain rules. The organization would have to reapply as a tax-exempt organization and start the process over. Revocations may result when an organization is found to be engaging in non-exempt activities, operating in a commercial manner, or allowing inurement of net earnings or assets of the organization to benefit an officer, director, or a key employee who has a personal or private interest in the activities of the organization. This type of enforcement action happens infrequently.

An exam may also identify issues—such as a proposed expansion of an unrelated business income producing activity, or a failure to properly report required information, such as special fundraising activities or officer compensation. If enlarged, these issues could jeopardize the tax-exempt status of the organization. However, there is no change in the tax-exempt status of the organization. Instead, the examiner will issue a closing letter with a written advisory addendum to the organization identifying the non-compliance issues found during the examination which, if corrected, would bring the organization into compliance.

**Table 5: Number of Charitable Organization Examinations Closed and Results, Fiscal Years 2011- 2013**

Fiscal year	Number of return closures	Percent of return closures with no-change <sup>a</sup>	Percent of return closures with written advisory	Percent of return closures with agreed tax or penalty	Percent of return closures with agreed termination <sup>b</sup>	Percent of return closures with revocation	Delinquent return secured/ related return secured	Other <sup>c</sup>	Total results
2011	5,888	30%	14%	15%	1%	4%	19%	16%	100%
2012	5,864	34%	11%	23%	1%	2%	18%	12%	100%
2013	5,426	30%	16%	27%	1%	3%	14%	10%	100%

Source: GAO Analysis of IRS data from IRS Return Inventory Classification System. | GAO-15-164

Note: Percentages do not total to 100 due to rounding.

<sup>a</sup>Does not include written advisories, as those are considered a change.

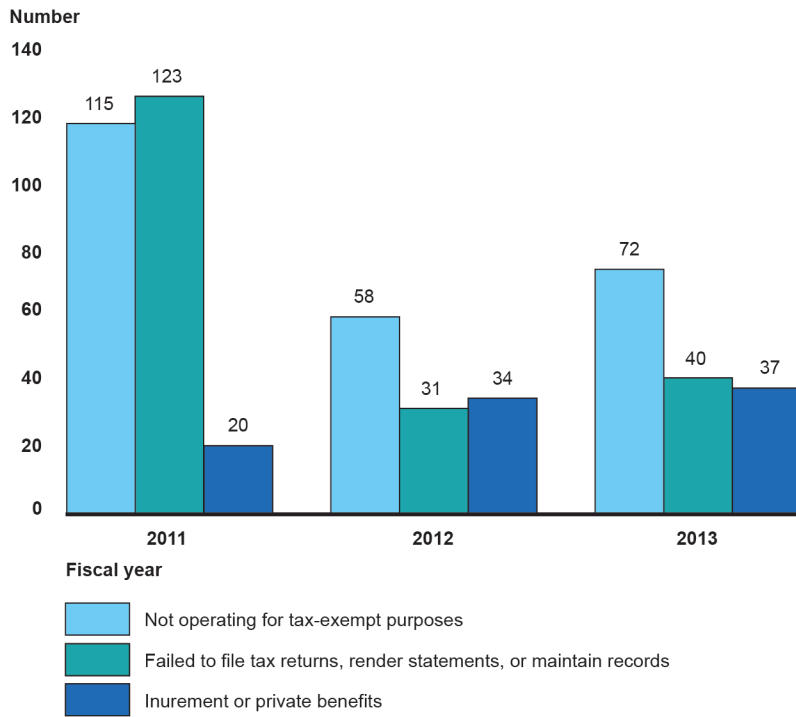
<sup>b</sup>IRS cannot initiate the termination of an organization. Termination occurs when a tax-exempt organization notifies IRS that it has ended its operations, either through shutting down, transferring its assets, or merging with another tax-exempt organization.

<sup>c</sup>Includes results such as those unagreed by the taxpayer, or changes by IRS to a taxpayer's related return, such as a prior-year return.

As figure 6 shows, the number of charitable organization returns with revocations declined from 2011 to 2013. Generally, the most often-cited reason for the revocation was that the charitable organization was not operating for a charitable purpose. The exception was in 2011, where the failure to file returns and other records was slightly higher. Operating for the benefit of private interests was another reason for a revocation.<sup>31</sup>

<sup>31</sup>A section 501(c)(3) organization must not be organized or operated for the benefit of private interests, such as the creator or the creator's family, shareholders of the organization, other designated individuals, or persons controlled directly or indirectly by such private interests. No part of the net earnings of a section 501(c)(3) organization may inure to the benefit of any private shareholder or individual. A private shareholder or individual is a person having a personal and private interest in the activities of the organization.

**Figure 6: Number of Charitable Organization Returns with Revocations and the Reasons, Fiscal Years 2011-2013**



Source: GAO analysis of data provided by IRS officials. | GAO-15-164

Note: These revocations are from examinations and do not include automatic revocations based on failure to file for three consecutive years.

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## The Impact of EO Compliance Efforts on Charitable Organizations Is Unknown, Due to Lack of Key Performance Measures and Goals and Lack of Complete Data

The EO Business Division has faced challenges over the past several years from declining budgets and staffing and from the complexity and the sensitivity of their workload, which includes regulating the political activity of tax-exempt organizations. EO's ability to address these challenges has been hindered by a lack of performance measures that EO management could use to fully assess and communicate how effective their efforts have been. EO managers have introduced some timeliness measures that may lead to efficiency gains by helping them track their inventory of applications, referrals, and exam cases and identify bottlenecks as they occur. However, EO managers lack compliance goals and measures for assessing their progress in ensuring that charitable organizations are conforming to their charitable purpose and other aspects of the tax law. EO is developing a new approach to identify and select organizations for examination. EO also introduced a streamlined application form for smaller organizations seeking tax-exempt status that may reduce administrative burden. However, the limited amount of information that will be available about these organizations raises questions about how IRS will identify noncompliance issues for this particular segment of charitable organizations. In addition, a lack of timely, accurate digitized data from the Form 990 further complicates oversight efforts.

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## Lack of Quantitative, Results-Oriented Goals and Measures for Improving Compliance Limits Ability to Assess Effectiveness of EO Oversight

EO has developed measures and goals to track its output of application reviews and examinations, but these do not measure impact on compliance. EO managers develop an annual work plan, which lists the research projects and exams they plan to initiate over the course of the year. The work plan includes goals for the number of cases they plan to start and close within the year, and the estimated number of staff days for each project. EO management uses a quarterly dashboard to track their progress against the workload goals, as set forth in their annual work plan. However, these performance goals and measures do not show the impact of EO efforts on compliance. These are measures that are useful for monitoring processes within EO, but they do not measure outcomes—such as improvements in the compliance rate for the charitable organization sector. Developing outcome-oriented goals and establishing measures to assess the actual results of EO activities (compared to their intended purpose) can help EO improve performance and determine whether programs have produced desired results.

EO Examinations managers use the examination change rate as a measure of compliance. The change rate is measured as the percentage of exams that result in a written advisory, a change in the amount of

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taxes, penalties, or fines an organization owes, or a change in the organization's tax-exempt status. This change rate that EO reports from exams may be a useful indicator of how accurately EO is selecting charitable organizations for exam but it has limitations as a compliance measure. EO does not use a random sample of organizations to estimate the change rate for the charitable sector as a whole and—except in the case of certain projects described below—it does not estimate the rate by type of charitable organization or by compliance issue. Change rates based on nonrandom exam selection procedures cannot be used to enhance compliance by focusing enforcement efforts on areas with the highest risk of noncompliance. In addition, EO's change rate is ambiguous as a measure of compliance because while it includes the number of written advisories that EO managers send following an exam, EO managers do not track the percentage of organizations that received a written advisory in the past and continued to be noncompliant.<sup>32</sup>

In addition to lacking some key compliance measures, EO managers do not set specific, measurable goals related to improving the compliance levels of tax-exempt organizations, either as a whole or for charitable organizations in particular. One reason it is difficult to set compliance goals, according to IRS and EO officials, is that IRS has not completed a study for charitable organizations that establishes a compliance baseline. In order to track progress toward a compliance goal, generally-accepted evaluation standards require establishing a baseline for compliance measures and recording how these measures change over time.

A possible source for such a baseline is IRS's National Research Program (NRP) but the cost of establishing a baseline may be large. The NRP examines a sample of tax returns to estimate rates of noncompliance for all taxpayers and for different types of taxpayers and tax issues. According to IRS and Exempt Organizations officials, it would be useful to have a research program like the NRP identify compliance baselines for EO. More compliance data on the EO sector would allow EO examiners to better select organizations for exam and would

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<sup>32</sup>Although some audits with a written advisory re-enter the EO audit stream and will be re-examined at a later date, they are not tracked in the aggregate once they re-enter the audit stream. EO considered a special project to review the impact of written advisories, and it was included in the work plan for years 2013 and 2014. However, managers reported those cases were not worked, due to resource issues and other competing higher priority work. This project is also not addressed in FY 2015 work plan.

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potentially reduce the no-change rate. However, these officials also point out that such a project requires a considerable investment of resources. They also say undertaking such a large-scale long-term project may not be feasible, given the resource constraints faced by IRS.

Another possible source of baseline data is the projects initiated by the EO Examinations Unit. EO Examinations sponsors new research projects each year to help identify non-compliance (which can include estimating a change rate) by types of operations, by segments of the charitable sector, or around a particular issue or item from the Form 990. A project can begin when EO decides that potential for noncompliance exists for a certain issue based on data analytic queries, referrals, or some other source (as described above). A random sample of organizations in that segment is selected for review. EO managers said they generally judge a project to be successful if it achieves a change rate of 80 percent or higher. For example, if 80 percent or more of the returns examined as part of the review result in a change in the amount of taxes, penalties, or fines the organization owes, a change in the organization's tax-exempt status, or a significant change in the organization's operations, EO managers may then decide to incorporate the original query as part of their regular examination selection criteria.

However, EO does not use the results of the projects as baselines to assess whether the strategies adopted as a result of the projects have improved compliance among the segments of the tax-exempt sector that were studied in the projects. EO managers see these projects as a way to gather information they can use to develop strategies to address emerging issues, measure overall levels of compliance, and address areas of known non-compliance. But the impact on compliance remains unclear, because EO does not consistently follow up to measure the project impact in subsequent years or policy changes made as a result of the project. Even when a full research project using a representative sample is not justified given EO's resource limitations, other approaches may still provide useful information about compliance. For example, tracking the frequency in exams of issues that were identified in the project, while not an adequate compliance measure due to the nonrandom exam selection procedures, could provide insight into whether the issues are still a reason for concern.

An example of how establishing a baseline could have helped EO measure the effect on compliance of policy changes is EO's project that reviewed charitable organizations providing consumer credit counseling. The project examined over 200 organizations and IRS revoked,

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terminated, or proposed revoking the exemptions of around 60 percent of these organizations for abuses such as failure to provide education, operating as a commercial business, or serving the private interest of directors, officers, and related entities. According to the 2011 Exempt Organizations Annual Report, this project helped to stimulate legislative changes in 2006, including new tax rules governing exempt credit counseling organizations.<sup>33</sup>

However, IRS has not evaluated the effect of changes in the law that came about as a result of the project on subsequent compliance by charitable organizations that provide credit counseling. Because the project examined over 200 of the credit counseling organizations, including the 63 largest, it may have had sufficient coverage of this part of the charitable sector to provide a baseline for assessing the effect of the legislative changes on compliance. According to EO officials, they decided not to open a large volume of new credit counseling cases after the initial project was completed because the initial project still had cases in the appeals process and the relevant sections of the 2006 legislation had phase-in provisions under which the provision took full effect for tax years after January 1, 2011. However, EO currently has no plans to undertake such a study in the future.

EO officials told us that they intend to change their source-based approach to selecting and conducting exams starting in 2015, in order to make better use of limited resources. They said they intend to rely more on data mining queries based on the redesigned Form 990 to detect high-risk areas of noncompliance and to prioritize enforcement efforts. This approach may also better conform to strategies IRS lays out in their strategic plan for 2014-2017, which calls for IRS to develop improved research-driven methods and tools to detect and combat noncompliance and improve resource allocation.<sup>34</sup> As an example, EO officials also report they will prioritize case selection according to criteria that give more weight to more consequential outcomes. A data mining query generating a lot of revocations would take priority over a query that may only

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<sup>33</sup>Section 1220(a) of the Pension Protection Act of 2006 added new Internal Revenue Code subsection 501(q), which establishes standards that a credit counseling organization must satisfy to qualify for exemption under Code subsections 501(c)(3) or 501(c)(4).

<sup>34</sup>Internal Revenue Service, *Strategic Plan, 2014-2017*, <http://www.irs.gov/pub/irs-pdf/p3744.pdf>.



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generate written advisories. They hope their new approach will allow them to better select cases for exam and to measure their effectiveness. However, this new approach is still in early stages of development and they are starting to implement it in FY 2015. Also, without compliance goals, related performance measures, and more complete indicators of compliance, it will be difficult to assess the effectiveness of the new strategy.

Developing measures of compliance and determining the impact of projects and exams on compliance is challenging. As we've discussed in past reports, IRS researchers have found it difficult to determine the extent to which its enforcement actions deter noncompliance or its services improve compliance among taxpayers who want to comply.<sup>35</sup> The challenges to determining impact include collecting reliable compliance data, developing reasonable assumptions about taxpayer behavior, and accounting for factors outside of IRS's actions that can affect taxpayer compliance, such as changes in the tax law. Nevertheless, even if IRS (or in this case, EO) is unable to empirically estimate the extent to which its actions directly affected compliance rates, periodic measurements of compliance levels can indicate the extent to which compliance is improving or declining and can provide a basis for reexamining existing programs and triggering corrective actions, if necessary.

Best practices indicate that establishing results-oriented goals can help agency officials demonstrate they have thought through how the activities and initiatives they are undertaking are likely to lead to meaningful results in line with programmatic goals. An example of a results-oriented goal for EO would be a specific, measurable increase in compliance rates for particular types of organizations (such as for the credit counseling organizations described above) or for certain issues that have been problematic in the past (such as failure to pay employment taxes). We have also previously reported that setting results-oriented goals, establishing performance measures and related performance indicators

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<sup>35</sup>For more information on difficulties we found in measuring compliance, see GAO, *Corporate Tax Compliance: IRS Should Determine Whether Its Streamlined Corporate Audit Process Is Meeting Its Goals*, [GAO-13-662](#), (Washington, D.C.; Aug. 22, 2013) and *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap*, [GAO-05-753](#) (Washington, D.C.; July 18, 2005).

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with targets in meeting such goals, and reporting on progress against those goals are the hallmarks of effective management.<sup>36</sup> The absence of results-oriented goals and related performance measures for compliance does not allow EO officials to compare the success of different initiatives against one another, determine whether their compliance strategy is working as intended, or allocate resources to those activities that have the most impact on compliance levels.

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### New Streamlined Application and Review Process Raises Questions about Whether IRS Will Collect Adequate Information to Identify Noncompliance among Smaller-Sized Organizations

In May 2013, Treasury Inspector General for Tax Administration (TIGTA) found that applicants for tax-exempt status experienced significant delays in the review of their applications.<sup>37</sup> Specifically, it reported that as of December 2012, many organizations had not received an approval or denial letter—more than two years after they submitted their applications. TIGTA also reported that the EO Rulings & Agreements function did not have specific timeliness goals for processing applications, such as potential political cases, that require significant follow-up with the organizations. The Taxpayer Advocate also reviewed EO operations and concluded that EO management did not have meaningful performance measures required for effective management oversight of the application process such as how long it takes, on average, to process applications that cannot be disposed of during initial screening and what percentage of inventory had not been reviewed in nine months or more.<sup>38</sup>

The lack of meaningful performance measures compounded other challenges faced by EO management. As discussed earlier, the number of charitable organizations recognized as tax-exempt by IRS increased

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<sup>36</sup>GAO, *The Results Act: An Evaluator's Guide to Assessing Agency Annual Performance Plans*, [GAO/GGD-10.1.20](#) (Washington, D.C.: April 1998) and GAO, *Streamlining Government: Questions to Consider When Evaluating Proposals to Consolidate Physical Infrastructure and Management Functions*, [GAO-12-542](#) (Washington, D.C.: May 23, 2012). Also, the Government Performance and Results Act of 1993 (GPRA), as updated by the GPRA Modernization Act of 2010, requires agencies to set results-oriented goals, to establish performance measures and related performance indicators with targets in meeting such goals, and to report progress. Pub. L. No. 103-62, 107 Stat. 285 (1993); Pub. L. No. 111-352, 124 Stat. 3866 (2011).

<sup>37</sup>Treasury Inspector General for Tax Administration, *Inappropriate Criteria Were Used to Identify Tax-Exempt Applications for Review*, 2013-10-053 (Washington, D.C.: May 14, 2013).

<sup>38</sup>National Taxpayer Advocate, *Fiscal Year 2014 Objectives Report to Congress and Special Report to Congress*, IR-2013-63 (Washington, D.C.: July 16, 2013).

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over the past decade, as the number of employees has declined along with budget cuts. In addition, the auto-revocation process that began in 2011 (following changes to legislation in 2006) inadvertently led to an increase in the number of applications. By revoking the status of organizations that had not filed in three years, the process revoked the status of hundreds of thousands of organizations that no longer existed as intended, but also purged thousands of organizations that still merited tax-exempt status, but may have been unaware of their filing requirements. Once their status was automatically revoked, many applied for reinstatement, leading to a spike in applications. According to IRS senior officials, other challenges faced by EO management included outdated information technology records management systems, making it difficult for managers to understand and manage the size of the application backlog.

EO managers introduced performance measures and goals to help address these challenges and the concerns about applications inventory raised by TIGTA and the Taxpayer Advocate. For fiscal years 2013 and 2014, EO managers set a goal to eliminate the backlog of applications waiting for review for 270 days or more. To assess their progress in managing the inventory of applications, EO managers focused on performance measures such as number of applications received and closed, average age of applications inventory, and number of cases still pending after 270 days. They anticipate that these measures will allow them (for the first time) to track their progress, to more readily identify choke points and the reasons why slowdowns are occurring, and to react accordingly. Managers can now access this information through a weekly dashboard to monitor the inventory and communicate to senior EO management on a quarterly basis. As of September 2014, IRS Exempt Organizations officials reported they had closed over 117,000 cases in FY 2014, an increase of 121 percent over the prior year's closings. They also reported that the end of year inventory was 22,759, as compared to 65,718 at the end of FY 2013.

EO managers also introduced a streamlined application review process to reduce their inventory of aged cases. Initially, application reviewers relied more heavily on attestation statements made under penalty of perjury, rather than with substantiating documents. For example, if an organization failed to include a narrative statement describing its activities as required by the application Form 1023, IRS would ask the organization

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to attest that it met the operational test for tax-exempt status, rather than hold the case open until the organization submitted the appropriate paperwork.<sup>39</sup> Similarly, applicants that failed to submit organizing documents—which are important because they describe how the organization’s purpose and assets comply with tax-exempt purposes set forth in section 501(c)(3)—would need to attest that they had the appropriate organizing documents and that they met statutory and regulatory requirements, rather than provide actual documents. EO officials said attestation statements allowed applicants to indicate that they were fully aware of the application requirements, but they were not used in isolation. For example, if an application indicated the possibility of private inurement, the reviewer was supposed to ask the applicant about this issue and would not rely solely on attestation. In the spring of 2014, EO managers determined the interim guidance for application reviewers was unclear, and they told reviewers there must be a narrative and organizing documents, although the IRM has not yet been updated to reflect this change. The new, streamlined procedures initially applied only to cases in the applications inventory that were more than a year old, but were extended in May, 2014 to all existing inventory. EO officials told us these streamlined review procedures are temporary and they are commissioning a study to evaluate their effectiveness and efficiency.

In addition, in July 2014, EO managers introduced a new application form for relatively small organizations. This application adopts the same approach of substituting attestation for documentation as used initially in the streamlined inventory procedure. The new application (Form 1023-EZ) can be used by certain organizations with annual gross receipts of \$50,000 or less and assets of \$250,000 or less seeking tax-exempt status.<sup>40</sup> This form is considerably shorter than Form 1023 (3 pages compared to 12 pages), asks fewer questions, and the questions are primarily yes/no questions or checking a box for attestation.<sup>41</sup> Form 1023-EZ does not require detailed information, such as organization documents, financial statements, or explanations, descriptions, or narratives about activities, as is required on Form 1023. EO managers

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<sup>39</sup>For more on the operational test, see appendix II.

<sup>40</sup>See Form 1023-EZ, *Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*.

<sup>41</sup>Including schedules for different types of organizations, the Form 1023 has 26 pages.

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anticipate that the majority of new applicants will use the streamlined Form 1023-EZ.

Several organizations, including the National Council of Nonprofits and National Association of State Charity Officials (NASCO) have raised concerns about the impact of the shorter application Form 1023-EZ on compliance. These concerns include decreasing the quality of information the IRS needs to make informed decisions about granting tax-exempt status, making it easier for “scam” charities to obtain tax-exempt status, and shifting IRS oversight obligations onto the public, the funding community, and state charity regulators. Likewise, the Taxpayer Advocate also raised concerns about the streamlined 1023-EZ form, including a lack of empirical data demonstrating that organizations anticipating less than \$50,000 in gross annual receipts pose low risks to compliance, a failure to conduct a comprehensive evaluation of downstream consequences of the streamlined application, and a post-implementation evaluation plan that relies on the limited effect of a small number of audits to correct potential compliance problems. EO officials told us they disagreed with the Taxpayer Advocate’s findings.

EO officials said that they conducted a risk assessment of their new streamlined application process. As part of the risk assessment, IRS identified several compliance-related risks, including the possibility of an increase in fraudulent applications and consequent potential loss of revenue, due to tax deductible contributions to organizations that were not eligible for exemption. To address these compliance risks, the IRS risk assessment cited the need for a more robust back-end review of newly-exempt organizations that had received their status through the streamlined process. This would include increased use of quality control checks, audits, and other reviews, and an enhanced EO Examination process to identify ineligible organizations.

EO managers intend to review a sample of organizations that used the Form 1023-EZ to apply for tax exempt status to learn about the population of organizations applying for exemption using the new, shorter form, including their eligibility to use the form. This phase started in July 2014 (when the new form was introduced to the public), and occurs after an organization submits an application and before IRS makes a determination on tax-exempt status. IRS plans to review a random sample of 3 percent—an estimated 1,260—of applications submitted

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using the new streamlined 1023-EZ form. According to EO officials, this sample size was based on a reliability factor and was then adjusted based on staffing resource capacity.<sup>42</sup> As part of determining eligibility to use the shorter form, the reviewers are supposed to request from the filers in the sample such items as a detailed description of past, present, and future activities, and revenues and expenses for the most recently completed year.

The EO Examinations function will also conduct post-determination (i.e. after tax exempt status has been determined) compliance reviews of organizations that applied for and received their tax-exempt status through the streamlined application review as well as organizations that applied for and received their tax-exempt status using the shorter Form-1023-EZ. The compliance reviews of the first group—organizations that received their tax-exempt status through the streamlined review process—will begin during FY 2015. For this review, EO plans to select a random sample of exempt organizations reviewed under the streamlined process to provide information about the subsequent compliance characteristics of organizations that received their status in this way. EO recently approved guidance for reviewing these returns, which lists potential areas of noncompliance, such as legislative or overseas activities, compensation issues, and unrelated business activity.

According to Tax-Exempt and Government Entities Division and EO officials, post-determination compliance reviews of organizations that used the Form 1023-EZ to apply for tax-exempt status will begin in late FY 2015 or early FY 2016. For this review, EO plans to take a random sample of exempt organizations that filed the Form 1023-EZ to provide information about the subsequent compliance characteristics of organizations that filed the shorter form. They anticipate they will use the same review procedures for the Form 1023-EZ exams as they use for the streamlined review process. However, they also report some modifications will be necessary due to the limited information on the EZ application itself as well as the fact that eligible organizations would typically be filing the Form 990-N as opposed to the more detailed Form 990 or even Form 990-EZ. The limited amount of information that will be

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<sup>42</sup>We did not assess the reasonableness of this sample plan because information in the sample plan was not sufficient for such a review. For example, the plan did not detail the reasonableness of the reliability factor choice, describe implementation of the sample, detail how the data would be analyzed, or show how the analysis would be presented.

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available about these organizations because of the shorter application form and information return raises questions about how IRS will identify noncompliance issues for this particular segment of charitable organizations.

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**Lack of Timely and Complete Data Limits IRS Ability to Provide Adequate Oversight of Charitable Organizations and to Provide for the Transparency of the Tax-Exempt Sector**

The e-filing rate for tax-exempt organizations is significantly lower than for other taxpayers and organizations. In 2013, 38 percent of Forms 990, 990-EZ, and 990-PF were filed electronically, while in 2011, 64 percent of partnerships and 66 percent of S Corporations filed electronically.<sup>43</sup> The lower rate is due in large part to current law, requiring only very small and very large tax-exempt organizations to file electronically.<sup>44</sup> Larger tax-exempt organizations (those that file at least 250 returns during the calendar year) are required to file electronically and smaller organizations (those that are excused from filing Form 990 or Form 990-EZ, generally because their gross receipts are normally less than \$50,000 annually), must file an annual notice (Form 990-N) in electronic format. Medium-sized organizations—those too big to file the Form 990-N, but not big enough to file 250 returns—are not required to file electronically.

This lower rate means that there is less digitized data available for data mining and analytics and that IRS will have higher labor costs. IRS officials said that having more return information available electronically might improve examination selection. For instance, when IRS examination specialists suggested filters for an EO project to use in identifying potentially noncompliant issues, the lack of available electronic data prevented EO from using all of the filters. Further, IRS officials estimate that mandated electronic filing would save EO more than an estimated \$1 million in labor costs over a three year period, although a complete study has not been performed.

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<sup>43</sup>GAO, Partnerships and S Corporations: IRS Needs to Improve Information to Address Tax Noncompliance, [GAO-14-453](#) (Washington, D.C.: May 14, 2014).

<sup>44</sup>Churches and governmental entities, as well as certain related organizations, generally do not have to file annual returns or notices. However, all tax-exempt organizations, including churches, must report unrelated business taxable income on Form 990-T, which currently cannot be filed electronically. In addition, tax-exempt political organizations must file Form 8872 periodically to report certain political contributions and expenditures. Form 8872 must be filed electronically only if the organization has, or expects to have, annual contributions or expenditures in excess of \$50,000.

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In the FY 2015 Budget proposal, the administration proposed that Congress expand e-filing for tax-exempt organizations.<sup>45</sup> Expanded e-filing may result in more accurate and complete data becoming available in a timelier manner, which in turn, would allow IRS to more easily identify areas of noncompliance. In our 2014 report on partnerships and S corporations, we recommended that Congress consider expanding the mandate for partnerships and corporations to electronically file their tax returns in order to cover a greater share of filed returns.<sup>46</sup> We concluded that increased e-filing would increase the amount of digitized data available to IRS, which examiners could then use to identify which partnership and S corporation tax returns could be most productive to examine. Since many charitable organizations are organized as not-for-profit corporations, the same mandate could also cover 501(c)(3) charitable organizations.

Any option for an e-filing mandate would impose some burden on some tax return filers if (for example) they do not already possess the e-filing technology and they need to get access to it. However, expanded e-filing could also reduce taxpayer burden, since greater accuracy would reduce false-positives, allowing IRS to identify “bad actors” rather than organizations who made mistakes on their returns. In addition, the burden could be mitigated. The 2015 budget proposal would allow transition relief for up to three additional years after the date of enactment to begin electronic filing, for smaller organizations and organizations for which electronic filing would be an undue hardship without additional transition time.

According to IRS, electronic filing also increases transparency for the tax-exempt community because more searchable data becomes publicly available faster than paper-filed returns, which must first be converted to machine readable format. Once publicly available, the Form 990 data may be used by donors to make more informed contribution decisions and by researchers, analysts, and entrepreneurs to understand the tax-exempt sector better and to create information tools and services to meet the needs of the sector. Having Form 990 series return data faster would also be useful to state and local regulators, charity watch-dog groups,

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<sup>45</sup>Department of Treasury, *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals*, (Washington, D.C.: March, 2014).

<sup>46</sup>[GAO-14-453](#).



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charitable beneficiaries, and the press. In addition, e-filing would allow the IRS to process returns more quickly and at a lower cost than when paper returns are filed. Representatives from across the nonprofit and law enforcement community with whom we spoke support this reform as a strategy for improving transparency and accountability.

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## Uncertainty about How Taxpayer Data Can Be Shared and Used Limits Collaboration between IRS and State Charity Regulators

To oversee charitable organizations, IRS collaborates with different federal and state entities, including DOJ and state charity regulators. IRS and DOJ officials identified no obstacles that prevent their collaboration for the enforcement of tax laws. IRS refers cases involving possible criminal matters to the DOJ Tax Division for investigation and possible prosecution. According to DOJ officials, the review and referral process is designed to maintain a separation between IRS and DOJ decision making to avoid the appearance of (or actual) abuse of executive power. As such, DOJ attorneys have little involvement with the IRS review and referral process. Once a case is referred to DOJ, prosecutors have access to the taxpayer information under IRC section 6103(h)(2).<sup>47</sup> DOJ Tax Division attorneys said they are familiar with the information-sharing framework under this IRC provision. This framework allows prosecutors access to the information they need to build a case.

However, state regulators and other subject matter specialists said statutory requirements for safeguarding taxpayer information and uncertainty about how these safeguards must be implemented limit state regulators' ability to use relevant information shared by IRS. They add that this may reduce regulators' ability to use that information to build cases against charitable organizations engaged in fraudulent or other criminal activity.

Barriers to information sharing between IRS and state charity regulators have been a long-standing challenge. Before legislation passed in 2006, IRS was only permitted to disclose to state charity regulators information concerning final denials of applications for tax-exempt status, revocations of tax-exempt status, and final notices of deficiencies.<sup>48</sup> In 2002 and

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<sup>47</sup>26 U.S.C. § 6103(h)(2).

<sup>48</sup>A proposed notice of deficiency, also known as a 30-day letter, notifies the taxpayer of a proposed change in their tax. The letter offers the taxpayer the opportunity to appeal this change. A final notice of deficiency is the 90-day letter.

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2005, we reported that this limited data sharing hampered state charity officials' efforts to identify charities which are defrauding the public or otherwise operating improperly.<sup>49</sup> At the time, state charity regulators told us that the lack of details impeded their efforts to track individuals who tried to re-establish similar, suspicious operations in other states. We recommended IRS propose revised legislation that would allow IRS to share more data—such as information about ongoing and closed examinations of charities—as a way to help IRS and states better use limited resources and to allow the states to more quickly respond to noncompliance.

In 2006, the PPA was enacted with provisions to facilitate information-sharing between IRS and state charity regulators.<sup>50</sup> The PPA expanded the type of information state charity regulators can receive to include sensitive, confidential information, such as revenue agents' reports regarding proposed revocations and notices of deficiencies.<sup>51</sup> IRS can now share information about certain proposed revocations and proposed denials before an administrative appeal is made and a final revocation or denial issued. In addition to the information IRS is now allowed to share with state charity regulators, IRS also makes revocations publicly available: IRS lists revocations in the Internal Revenue Bulletin, although the reason for revocations resulting from exam are not given or made public.<sup>52</sup>

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<sup>49</sup>[GAO-02-526](#) and [GAO-05-561T](#).

<sup>50</sup>Pub. L. 109-280, § 1224, 120 Stat. 780, 1091–1093 (2006) (*codified at* 26 U.S.C. § 6104(c)).

<sup>51</sup>Reporting on another piece of proposed legislation with a similar provision as that which was enacted in the PPA, the Senate Committee on Finance stated that by giving state officials “earlier access to information about the activities of certain section 501(c) organizations, state officials will be able to monitor such organizations more effectively and better protect the public’s interest in assuring that organizations that have been given the benefit of tax-exemption operate consistently with their exempt purpose.” The report also stressed the importance of maintaining the confidentiality of taxpayer data and stated the Committee’s belief that it was important to extend existing protections against unauthorized disclosure to disclosures of charitable organizations’ data. S. Rep. 108-11 at 43 (2003).

<sup>52</sup>IRS also makes public a list of charitable organizations that have had their tax-exempt status automatically revoked. Auto-revocations occur when an exempt organization fails to file the appropriate information return or notice three years in a row. This list does not include information about why an organization may have had its tax exempt status revoked for other reasons.

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While the PPA expanded the types of information IRS could share with state charity regulators, the law also placed safeguards on that information. For the first time, the PPA subjected state charity regulators to the same criminal penalty provisions of the Internal Revenue Code that all other recipients of tax information are subject to, making it a criminal offense for any state official to willfully disclose information shared by the IRS under Section 6104(c) in a manner unauthorized by the Internal Revenue Code. To have access to the increased types of information now available, state charity regulators must sign a disclosure agreement with IRS in which they agree to certain safeguarding procedures for receiving and handling taxpayer data.

State charity regulators and other subject matter specialists we spoke with believe these safeguard requirements are unclear and difficult to implement. Although these requirements are the same as those that IRS and any state tax agencies receiving federal tax data must follow, most states do not have the resources, capacity, or infrastructure within their charitable oversight function to fulfill the requirements, according to subject matter experts with whom we spoke. For example, all disclosures provided by IRS must be reviewed by a state charity official, logged to record the receipt of the information, and stored behind at least two secured barriers, such as locked doors or cabinets. State charity regulators are also prohibited from entering the IRS shared data in a word processing program on a networked computer, unless lengthy security requirements are met.

Since the passage of the PPA, charity regulators in three states—California, New York, and Hawaii—signed a memorandum of understanding (MOU) with IRS to share information. However, despite the MOU, these state charity regulators still report challenges in storing and receiving data from IRS. A lack of clarity surrounding how they can use the data from IRS to build their own cases, and the criminal penalties attached to improper disclosure of the data, have prevented state charity regulators from incorporating IRS data into their investigations. For example, state charity regulators said when they learn that IRS is examining a charity located in their state for violating federal tax law, they must first contact the charity and request the documents it has already turned over to IRS. However, if the charity refuses or denies it has the requested documents, the state charity regulators do not believe they can enforce their request by citing the information provided to them by IRS. As a result, they seek to independently verify the information from the IRS (to the extent they are available) through other sources (such as the internet or the state registration database) before contacting the charity.

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Also, according to subject matter experts, IRS interpretation of these rules has been inconsistent. As a result, regulators are unsure whether they are in violation of the safeguards requirements. According to state charity regulators, other states have not entered into information-sharing agreements with IRS because they view the safeguard requirements as overly burdensome, given their limited resources.

NASCO and the National Association of Attorneys General (NAAG) representatives credit IRS with trying to educate state regulators about the PPA requirements. IRS staff has given presentations at joint NAAG and NASCO conferences. According to the ACT 2013 report on exempt organizations, the IRS's designated EO federal/state liaison has worked to educate participating state agencies in the mechanics of PPA participation, has assisted with the safeguard procedure, and has linked state officials with appropriate IRS officials conversant in necessary information technology and security issues.<sup>53</sup> The report also credited IRS with initiating discussions with state charity regulators through a task force to develop a pragmatic approach for taking advantage of what is presently available under the PPA. IRS officials are also working on a new MOU that will clarify how state charity regulators can communicate to charities to let them know they have received information about them from IRS. In addition, to facilitate information sharing between IRS and state charity regulators, Treasury officials are in the process of reviewing the PPA and Congress's intent in drafting this legislation to determine whether additional flexibilities exist.

Despite these education and outreach efforts, state charity regulators are still unclear about how they are permitted to use IRS information to identify organizations violating state law and to build cases against them. The types of information PPA makes available would bolster state oversight efforts in a variety of ways. For example, according to the ACT report, state receipt of the names of organizations applying for exempt status would help states monitor startup entities that cease operations before the IRS responds to their for 1023 applications. EO officials told us that there are efforts underway to reduce processing times that should address this particular concern. Also according to the ACT report, state

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<sup>53</sup> The twelfth report of recommendations of the Advisory Committee on Tax Exempt and Government Entities (ACT), *Exempt Organizations: Leveraging Limited Resources in the Tax Administration of Small Tax-Exempt Organizations* (Washington, DC: September 12, 2013).

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receipt of information about tax-exempt organizations receiving a proposed revocation of exemption would raise immediate questions about whether those organizations' assets are being properly applied to charitable purposes as required by state law.

The challenges to information sharing between IRS and state charity regulators are related to uncertainty about what is permissible under the PPA. With limited access to IRS information, state charity regulators do not always know why a charity has had its tax-exempt status revoked, if it is under examination, or if it has been fined, but maintains its tax-exempt status. The lack of information impedes state charity regulators' ability to identify and prosecute bad actors for violating state laws and hinders states' ability to inform donors of scam charities.

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## Conclusions

EO oversight of charitable organizations helps ensure that these entities abide by the purposes that justify their tax exemption and protects the sector from potential abuses and loss of confidence by the donor community. Over the past several years, reviewers have found that various units within the EO division could not fully assess or communicate their effectiveness because they lacked meaningful performance measures. EO managers have taken actions to address this deficiency by adding performance measures to help them track their inventory of applications, referrals, and exam cases and to ensure a level of quality assurance. EO has also developed its data analytics capacity to assist in selecting organizations for exam with greater audit potential. It has used these techniques and other information sources to select returns for examination and in some cases, has used the results of these exams to more systematically review certain tax issues. However, these actions have not addressed measuring the outcomes of EO activities (such as the effect of EO's actions on the compliance rate for the charitable sector as a whole), for specific segments of the sector (such as universities and hospitals), or for particular aspects of noncompliance (such as personal inurement or political activity). EO does not have the compliance measures or the quantitative, results-oriented compliance goals needed to assess its effect on the compliance of charitable organizations in any of these areas. Because EO does not measure the current level of compliance, it cannot set goals for increasing compliance or know to what extent its actions are affecting compliance.

The Exempt Organizations Business Division is grappling with several other challenges that complicate oversight efforts. The e-filing rate for tax-exempt organizations is significantly lower than for other taxpayers. This

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lower rate means that there is less digitized data available for data mining and analytics and higher labor costs for IRS. Expanded e-filing may result in more accurate and complete data becoming available in a timelier manner; in turn this would allow IRS to more easily identify areas of noncompliance. This legislative reform would also be useful to state and local regulators, charity watch-dog groups, charitable beneficiaries, and the press as a strategy for improving transparency and accountability.

A lack of clarity about how state charity regulators can use IRS data to build cases against suspect charitable organizations impedes regulators' ability to leverage IRS's examination work. IRS and Treasury officials are reviewing the statutory protections of taxpayer data and whether there is flexibility in regard to how state regulators must protect and can use federal tax data. IRS officials are also working on a new MOU that will clarify how state charity regulators can communicate to charities about information they have received from IRS. Once completed, these actions have the potential to enable greater collaboration between IRS and state charity regulators.

IRS budget and staffing levels have declined significantly over recent years. Officials and stakeholders we spoke to noted that IRS resources dedicated to EO oversight have not kept pace with growth in the sector and with the complexity of issues related to tax-exempt organizations. IRS faces difficult decisions about how to allocate resources dedicated to tax-exempt sector oversight and about what specific compliance issues to audit. IRS has already made trade-offs—such as examining fewer organizations and streamlining the application process for organizations seeking tax-exempt status—which may lead to some efficiencies, but will also result in less available information about these organizations. If IRS does not collect and use performance data to make sound decisions—especially given the likelihood of constrained budgets for the foreseeable future—the agency risks missing noncompliance, burdening tax-exempt organizations, and wasting scarce resources. Furthermore, it will be difficult for IRS to communicate agency progress to Congress and the public and thus, be held accountable.

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## Matter for Congressional Consideration

Congress should consider expanding the mandate for 501(c)(3) organizations to electronically file their tax returns to cover a greater share of filed returns.

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## Recommendations

To improve oversight of charitable organizations, we recommend that the Commissioner of Internal Revenue take the following steps:

1. Direct EO to develop quantitative, results-oriented compliance goals and additional performance measures and indicators that can be used to assess impact of exams and other enforcement activities on compliance.
2. Continue to work with Treasury officials to do the following: review the flexibility afforded under PPA consistent with statutory protections of taxpayer data, clarify what flexibility state regulators have in how they protect and use federal tax data, make modifications to guidance, policies, or regulations as warranted, and clearly communicate this information with state charity regulators.

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## Agency Comments and Our Evaluation

We sent a draft of this report to the Commissioner of Internal Revenue and Assistant Attorney General for Administration, Department of Justice for comment. DOJ had no comments on our report. We received written comments from IRS's Deputy Commissioner for Services and Enforcement on December 4, 2014 (for the full text of the comments, see appendix IV).

In its comments, IRS concurred with our recommendations and described ongoing and planned steps to 1) improve the application process for organizations seeking tax-exempt status and reduce the backlog of applications that had accrued in recent years, 2) refine its strategy and approach to better determine the effect of enforcement actions on compliance by tax-exempt organizations, including charitable organizations, and 3) improve the efficiency with which taxpayer information may be shared with state charity regulators through education efforts and outreach.

IRS also noted in its written comments that IRS's National Research Program (NRP) may not be well-suited for the tax-exempt sector, given the diversity that exists across the sector in regard to characteristics and compliance issues. Although we made no specific recommendation that EO be part of an NRP study, we note that the NRP has helped other IRS divisions determine compliance baselines and rates for types of taxpayers, such as corporations, where considerable diversity exists. While an NRP study could be a source for baseline data, we acknowledge that because of the high cost of such a study, it may not be practical at this time. Whatever approach to measuring compliance EO adopts, it should be consistent with our recommendation that EO develop

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quantitative, results-oriented compliance goals and additional performance measures that can be used to assess the impact of its activities on compliance.

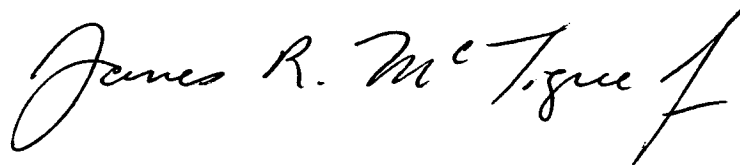
We also received technical comments from IRS, which we incorporated into the final report where appropriate.

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We plan to send copies of this report to the Secretary of the Treasury, the Commissioner of Internal Revenue, the Assistant Attorney General for Administration, DOJ, and other interested parties. The report is available at no charge on the GAO website at <http://www.gao.gov>.

If you or your staff has any questions about this report, please contact us at (202) 512-9110 or [mctiguej@gao.gov](mailto:mctiguej@gao.gov). Contact points for our offices of Congressional Relations and Public Affairs are on the last page of this report. GAO staff members who made major contributions to this report are listed in appendix V.

Sincerely yours,

A handwritten signature in black ink that reads "James R. McTigue". The signature is written in a cursive style with a large, stylized initial "J" and "M".

James R. McTigue  
Director, Tax Issues  
Strategic Issues Team



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# Appendix I: Scope and Methodology

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This report (1) describes what is known about the number, type, size, and other characteristics of 501(c)(3) charitable organizations; (2) describes IRS oversight activities for charitable organizations; (3) determines how IRS assesses its oversight efforts of charitable organizations to ensure they are meeting their charitable purposes; and (4) determines how IRS collaborates with state charity regulators and U.S. Attorneys to identify and prosecute organizations suspected of engaging in fraudulent or other criminal activity.

To address the first objective, we reviewed Internal Revenue Service (IRS) forms and publications. We also analyzed data from the IRS's Statistics of Income (SOI) files for Form 990, Return of Organization Exempt from Income Tax and Form 990-EZ Short Form, Return of Organization Exempt from Income Tax for tax year 2011 (the most recent year available). Although private foundations are considered charitable organizations, we did not analyze data from Form 990-PF, Return of Private Foundation or Form 990-N, e-Postcard because the data for these organizations is less complete and has other limitations. These limitations included total expenses not broken out into program service, management and general, and fundraising expenses; and private foundations not identified by mission category. In addition, our data excludes certain religious organizations, which qualify as 501(c)(3) organizations, but are not required to file a return. We also did not report data from prior years for the Form 990 and 990-EZ filers since the reporting threshold for organizations filing these returns varied from year to year, which makes year-to-year comparisons of the data difficult. These SOI samples were based on returns as filed, and did not reflect IRS audit results. Using SOI sampling weights, we estimated sampling errors for our estimates, which are reported in appendix III. Statements of difference are statistically significant.

SOI is a data set widely used for research purposes. SOI data on tax-exempt organizations are available to the public on the IRS website (<http://www.irs.gov>). IRS performs a number of quality control steps to verify the internal consistency of SOI sample data. For example, it performs computerized tests to verify the relationships between values on the returns selected as part of the SOI sample, and manually edits data items to correct for problems, such as missing items. We conducted several reliability tests to ensure that the data excerpts we used for this report were complete and accurate. For example, we electronically tested the data and used published data as a comparison to ensure that the data set was complete. To ensure accuracy, we reviewed related

documentation and electronically tested for obvious errors. We concluded that the data were sufficiently reliable for the purposes of this report.

For the second objective, we reviewed IRS documentation and interviewed Exempt Organization (EO) officials on IRS oversight activities, such as the examination and revocation of charitable organizations. We also obtained data from IRS's Return Inventory Classification System (RICS) on examinations and results for fiscal years 2011 through 2013. Based on our review of documentation and interviews, we determined that this data was reliable for the purposes of this report. We also obtained data from IRS's Referral database on referrals received on charitable organizations and all tax-exempt organizations for fiscal years 2011 through 2013. Although we received referral data on charitable organizations, we did not use the data because we found it was not reliable for the purposes of this report. According to EO officials, reviewers were encouraged but not required to enter the organization's subsection category (i.e. that it was a 501(c)(3) charitable organization) into the referrals data base. The EO officials said that if the referral was found to have "no issue" by the reviewer, it may not have been assigned a subcategory because the subcategory was not required and it would be viewed (in this case) as not useful. Therefore, data on the number of referrals received, the source of referrals, and the type of referral violations that we received could have been undercounted if the data had been used. Although we did not use charitable organization referral data, we did use referral data on all tax-exempt organizations, as we found that data was reliable for the purposes of this report.

For the third objective, we reviewed relevant strategic and performance documents such as the annual reports and work plans, quarterly performance reports, and project summary reports. We interviewed IRS planning officials and division managers to determine the extent to which managers overseeing the tax-exempt sector set performance goals; develop measures to monitor their progress toward meeting goals; and use data to identify challenges, the cause of those challenges, and develop strategies to address those challenges. We reviewed past recommendations made by the Treasury Inspector General for Tax Administration (TIGTA) and National Taxpayer Advocate related to performance management and interviewed IRS managers about how they addressed the issues discussed in those reports. For criteria, we compared IRS information on performance measures and decision-

making to *Standards for Internal Control in the Federal Government* and federal guidance on performance management.<sup>1</sup> We also applied the criteria concerning the administration, compliance burden and transparency that characterize a good tax system, as developed in our guide for evaluating tax reform proposals.<sup>2</sup> We also reviewed IRS plans to streamline the application process through the introduction of Form 1023EZ. We interviewed EO officials on how they plan to assess the impact of the new streamlined process on oversight efforts and reviewed available evaluation plans. We applied criteria from our 2012 guide on designing evaluations.<sup>3</sup>

To determine how IRS collaborates with state charity regulators and U.S. Attorneys, we reviewed various IRS documents, such as policy manuals, guidance, and memoranda of understanding. We also interviewed officials from IRS, U.S. Department of Justice (DOJ), and the National Association of State Charity Officials. For criteria, we identified different approaches for sharing information and collaboration based on our audit findings, as well as our past recommendations and recommendations made by the Advisory Committee on Tax Exempt and Government Entities.<sup>4</sup>

To provide additional context for all three objectives, we interviewed IRS officials, DOJ officials, state charity regulators, subject matter specialists, and stakeholder groups representing different types of exempt-organizations and private watchdog organizations that oversee charities about the adequacy of IRS oversight of charitable organizations; the challenges IRS faces providing effective oversight; and strategies to address those challenges.

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<sup>1</sup> GAO, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1, 1999)

<sup>2</sup> GAO, *Understanding the Tax Reform Debate: Background, Criteria, & Questions*, GAO-05-1009SP (Washington, D.C.: Sept. 1, 2005)

<sup>3</sup> GAO, *Designing Evaluations, 2012 Revision*, GAO-12-208G (Washington, D.C.: Jan. 31, 2012).

<sup>4</sup> GAO, *Tax-Exempt Sector: Governance, Transparency, and Oversight are Critical for Maintaining Public Trust*, GAO-06-561T (Washington, D.C.: Apr. 20, 2005) and *Tax-Exempt Organizations: Improvements Possible in Public, IRS, and State Oversight of Charities*, GAO-02-526 (Washington, D.C.: Apr. 30, 2002).

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# Appendix II: Tax Benefits and Requirements for Different Types of Tax Exempt Organizations

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The federal tax code provides a variety of tax benefits to organizations often referred to as “tax exempt.” The exact nature of those benefits varies depending on the nature of the organization. Section 501 provides an exemption from federal income tax for the broadest range of organizations.<sup>1</sup> In addition to section 501, there are various other scattered provisions which give a full or partial tax exemption to certain specific types of entities and income.<sup>2</sup> This appendix focuses on organizations qualifying for a tax exemption under section 501, which will be referred to as tax exempt organizations. Within section 501, there is a division between charitable organizations, also known as 501(c)(3) organizations (after the subsection in which they are defined), and all other organizations qualifying for an exemption under section 501. The organizations that qualify for an exemption under section 501 but are not charitable organizations have been referred to as mutual benefit organizations or non-charitable nonprofits. Charitable organizations are further divided between those that are private foundations and all other charitable organizations, and private foundations are divided between operating and non-operating foundations. Each of these types of tax exempt organization—(1) mutual benefit organization, (2) charitable organization, (3) operating private foundation, and (4) non-operating private foundation—are subject to different requirements and receive different tax benefits.

Tax exempt organizations of all types are prohibited from engaging in certain transactions with the creator of an organization, a person who made a substantial contribution to the organization, a member of the family of the creator or substantial contributor, or a corporation controlled by a creator or substantial contributor.<sup>3</sup> Additionally, an organization

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<sup>1</sup>Unless otherwise noted, all section numbers refer to the Internal Revenue Code.

<sup>2</sup>Certain farmers’ cooperatives, shipowners’ protection and indemnity associations, political organizations, and homeowners associations are wholly or partially tax exempt. 26 U.S.C. §§ 521, 526, 527, 528. Qualified tuition programs established by states (also called 529 plans) and Coverdell education savings accounts are exempt from federal income taxes. 26 U.S.C. § 529, 530. Income accruing to possession of the United States and political subdivisions thereof, states and political subdivisions thereof, and the District of Columbia, from any essential governmental function or public utility is not included in gross income and therefore not taxed. 26 U.S.C. § 115. Income earned by foreign governments and international organizations from investments in the United States is generally exempt from taxation. 26 U.S.C. § 892.

<sup>3</sup>26 U.S.C. § 503(b).

operated for the primary purpose of carrying on a trade or business for profit is not exempt, on the grounds that all of its profits are payable to an exempt organization.<sup>4</sup> These restrictions apply to all types of tax exempt organizations. Certain types of mutual benefit organizations and all charitable organizations are also subject to the restriction that no part of their net earnings inures to the benefit of any private shareholder or individual. Additionally, a tax is imposed on income from any trade or business unrelated to the exercise or performance of the organization's exempt purpose.<sup>5</sup>

Charitable organizations, a subset of tax exempt organizations meeting the definition in section 501(c)(3) are as follows:

“Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided [elsewhere]), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.”

As stated above, no part of a charitable organization's net earnings can inure to the benefit of any private shareholder or individual. Additionally they must satisfy two tests: the organizational test and the operational test. To pass the organizational test, an entity must be organized exclusively for one or more exempt purposes, meaning that the governing instrument (such as a trust instrument, articles of incorporation, or association charter) must limit the purposes of the organization to one or more exempt purposes and does not expressly empower the organization to engage in activities not in furtherance of an exempt purpose except to an insubstantial degree.<sup>6</sup> The operational test requires that organizations engage primarily in activities that accomplish one or more of the exempt

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<sup>4</sup>26 U.S.C. § 502. These organizations are sometimes called feeder funds.

<sup>5</sup>26 U.S.C. §§ 511–513.

<sup>6</sup>26 C.F.R. § 1.501(c)(3)-1(b).

purposes listed in statute.<sup>7</sup> In general, new organizations seeking charitable organization status must apply for a determination of exempt status.<sup>8</sup> Churches, their integrated auxiliaries, and conventions or associations of churches, as well as organizations with gross receipts of \$5,000 or less and that are not private foundations do not need to apply.<sup>9</sup>

Organizations which meet all the requirements to be charitable organizations receive tax benefits beyond those available to mutual benefit organizations. Contributions of cash or property to charitable organizations are deductible by individuals and corporations for federal income tax purposes up to certain percentages of adjusted gross income.<sup>10</sup> Such contributions are also exempt for estate and gift tax purposes.<sup>11</sup> Charitable organizations are exempt from the federal unemployment tax<sup>12</sup> and the federal gambling tax on lotteries.<sup>13</sup> Additionally, charitable organizations are exempt from certain requirements related to establishing and maintaining retirement plans for employees.<sup>14</sup>

Within the category of charitable organizations are private foundations. When applying for charitable organization status, an applicant is presumed to be a private foundation unless it can demonstrate that it is not a private foundation.<sup>15</sup> A charitable organization is not a private foundation if it is a church or convention or associations of churches, an educational institution, a medical or hospital care provider, medical

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<sup>7</sup>26 C.F.R. § 1.501(c)(3)-1(c).

<sup>8</sup>26 U.S.C. § 508(a).

<sup>9</sup>26 U.S.C. § 508(c); 26 C.F.R. § 1.508-1(a).

<sup>10</sup>26 U.S.C. § 170. Gifts to certain mutual benefit organizations (veteran groups, nonprofit cemetery companies, and fraternal beneficiary organizations) that use the gift for charitable purposes are deductible.

<sup>11</sup>26 U.S.C. §§ 2055, 2522.

<sup>12</sup>26 U.S.C. § 3306(c)(8).

<sup>13</sup>26 U.S.C. § 4421(2)(B).

<sup>14</sup>26 U.S.C. § 403(b).

<sup>15</sup>26 U.S.C. § 508(b). Organizations that are exempt from the application requirement are also exempt from this presumption.

education or research provider, or a government unit. A charitable organization is also not a private foundation if it is broadly publicly supported, as defined in section 509, or is a supporting organization of a broadly publicly supported organization. Organizations organized and operated exclusively for testing for public safety are also not private foundations. Charitable organizations not meeting one of these definitions are private foundations.

Private foundations are subject to certain tax consequences which do not apply to other charitable organizations. A 2 percent excise tax is imposed on the net investment income of private foundations.<sup>16</sup> A private foundation is also subject to additional taxes if it engages in self-dealing, has excessive business holdings, makes investments which jeopardize its charitable purpose, or makes certain taxable expenditures.<sup>17</sup> Finally, private foundations are subject to additional reporting requirements.<sup>18</sup>

Additional taxes and restrictions are imposed on foundations which do not meet the definition of an operating foundation. A private foundation is an operating foundation if it uses at least 85 percent of its income directly for the active conduct of charitable activities rather than for grantmaking and meets either an asset test, endowment test, or support test.<sup>19</sup> Private foundations that are not operating foundations are generally subject to a tax of 30 percent of the amount of undistributed income.<sup>20</sup> The percentage limits on the deductibility of contributions to non-operating private foundations are lower than for other charitable organizations.<sup>21</sup>

Aside from charitable organizations, section 501 lists 28 other types of nonprofits, often referred to as mutual benefit organizations, and which include unions, civic leagues, chambers of commerce, credit unions, and veteran organizations, among many others. For a complete list of the organizations listed in section 501, including charitable organizations, see

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<sup>16</sup>26 U.S.C. § 4940.

<sup>17</sup>26 U.S.C. §§ 4941, 4943–4945.

<sup>18</sup>26 U.S.C. § 6033(c).

<sup>19</sup>26 U.S.C. § 4942(j)(3); 26 C.F.R. § 53.4942(b)-1.

<sup>20</sup>26 U.S.C. § 4942.

<sup>21</sup>26 U.S.C. § 170(b)(1)(A)(vii), (b)(1)(F).

below. Qualified pension, profit-sharing, and stock bonus plans are also exempt under section 501.<sup>22</sup> Unlike charitable organizations, gifts to these mutual benefit organizations are not deductible. Mutual benefit organizations are not generally exempt from the federal unemployment tax or the gambling tax, and do not have the additional flexibility in establishing employee retirement plans that is allowed charitable organizations.

Types of Tax Exempt  
Organizations Listed in Section  
501

- Corporations organized by Act of Congress; Central Liquidity Facility for Federal Credit Unions; Resolution Trust Corporation; Resolution Funding Corporation
- Title-holding corporations
- Charitable organizations, including public charities, private foundations, religious, charitable, scientific, testing for public safety, literary, or educational, fostering national or international amateur sports competition, prevention of cruelty to children or animals
- Civic leagues, social welfare organizations, local associations of employees dedicated to charitable, educational, or recreational purposes
- Labor unions, agricultural, or horticultural organizations
- Trade associations, professional football leagues
- Social and recreational clubs
- Fraternal benefit societies providing payment of certain benefits to members
- Voluntary employees' beneficiary associations providing payment of certain employee benefits
- Domestic fraternal societies whose net earnings are devoted to religious, charitable, scientific, literary, educational, and fraternal purposes, which do not provide benefits to members
- Teachers' retirement fund associations
- Benevolent life insurance associations, mutual ditch or irrigation companies, mutual or cooperative telephone, electric, or water companies
- Cemetery companies
- Credit unions
- Small mutual insurance companies
- Corporations to finance crop operations

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<sup>22</sup>26 U.S.C. §§ 501(a), 401(a).



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**Appendix II: Tax Benefits and Requirements  
for Different Types of Tax Exempt  
Organizations**

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- Supplemental unemployment benefit trusts
- Pre-June 25, 1959 trusts to fund pension benefits
- Veterans' groups
- Group legal service organizations
- Black lung benefit trusts
- Multi-employer pension plan trusts
- Armed Forces insurance organizations established before 1880
- Employee Retirement Income Security Act trusts for certain terminated plans
- Multi-parent holding companies
- State-sponsored, high-risk insurance organizations
- State-sponsored worker compensation reinsurance organizations
- National railroad retirement investment trust
- Co-op health insurance issuers

# Appendix III: Additional Tables

The tables in this statistical appendix supplement those in the letter and provide population estimates for Statistics of Income (SOI) data. After each table, notes indicate the sampling errors. We are confident the true estimates would be within these percentage points in 95 out of every 100 samples. The tables are for charitable organizations that filed Forms 990 or 990-EZ. Private foundations that file Form 990-PF, small charitable organizations that file Form 990-N, and charitable organizations that do not file returns have been excluded from this analysis.

**Table 6: Number of Charitable Organization Filers by Mission Category, Tax Year 2011**

Mission category	Number of filers	Percent
Arts, culture, and humanities	27,107	9.9
Education	47,928	17.5
Environment and animals	11,763	4.3
Health	35,267	12.9
Human services	105,444	38.4
International and foreign affairs	5,744	2.1
Public and social benefit	24,718	9.0
Religion-related	15,628	5.7
Mutual and membership benefit	687	0.3
<b>Total</b>	<b>274,287</b>	<b>100.0</b>

Source: GAO analysis of SOI data from Forms 990 and 990-EZ. | GAO-15-164

Note: All percent estimates have 95 percent confidence intervals that are within +/- 2 percentage points of the estimate itself. We excluded a very small sample of unknown or unclassified charitable organization filers from our analysis. Therefore, the amounts may not equal the total due to this exclusion and to rounding.

**Table 7: Reported Amounts of Assets, Revenues, and Expenses of Charitable Organizations by Mission Category, Tax Year 2011**

Mission category	Number of filers	Total assets (in millions)	Percent	Total revenues (in millions)	Percent	Total expenses (in millions)	Percent
Arts, culture, and humanities	27,107	106,969	3.5	30,458	1.8	28,756	1.8
Education	47,928	1,023,648	33.8	317,196	19.2	297,691	19.1
Environment and animals	11,763	42,837	1.4	16,103	1.0	14,546	0.9
Health	35,267	1,238,533	40.9	947,494	57.5	902,599	57.9
Human services	105,444	323,735	10.7	216,322	13.1	209,273	13.4
International and foreign affairs	5,744	32,048	1.1	27,677	1.7	25,309	1.6
Public and social benefit	24,718	218,573	7.2	80,800	4.9	69,165	4.4
Religion-related	15,628	25,217	0.8	9,295	0.6	8,624	0.6
Mutual and membership benefit	687	18,557	0.6	2,462	0.1	2,339	0.2
<b>Total</b>	<b>274,287</b>	<b>3,030,133</b>	<b>100.0</b>	<b>1,647,905</b>	<b>100.0</b>	<b>1,558,401</b>	<b>100.0</b>

Source: GAO analysis of SOI data from Forms 990 and 990-EZ. | GAO-15-164

Note: All percent estimates have 95 percent confidence intervals that are within +/- 2 percentage points of the estimate itself. We excluded a very small sample of unknown or unclassified charitable organization filers from our analysis. Therefore, the amounts may not equal the total due to this exclusion and to rounding.

**Table 8: Reported Amounts of Assets, Revenues, and Expenses of Charitable Organizations, Tax Year 2011**

Asset size category	Number of filers	Percent	Amount of assets (in millions)	Percent	Amount of revenues (in millions)	Percent	Amount of expenses (in millions)	Percent
Under \$100,000	92,880	33.9	3,533	0.1	16,454	1.0	16,188	1.0
\$100,000 under \$500,000	69,185	25.2	17,097	0.6	26,751	1.6	25,705	1.6
\$500,000 under \$1,000,000	28,376	10.3	20,766	0.7	20,063	1.2	19,704	1.3
\$1,000,000 under \$10,000,000	62,488	22.8	207,027	6.8	174,150	10.6	171,684	11.0
\$10,000,000 under \$50,000,000	14,713	5.4	315,174	10.4	209,785	12.7	201,379	12.9
\$50,000,000 or more	6,645	2.4	2,466,537	81.4	1,200,702	72.9	1,123,740	72.1
<b>Total</b>	<b>274,287</b>	<b>100.0</b>	<b>3,030,133</b>	<b>100.0</b>	<b>1,647,905</b>	<b>100.0</b>	<b>1,558,401</b>	<b>100.0</b>

Source: GAO analysis of SOI data from Forms 990 and 990-EZ. | GAO-15-164

Note: All percent estimates have 95 percent confidence intervals that are within +/- 2 percentage points of the estimate itself. Amounts may not equal the total due to rounding.

**Table 9: Charitable Organization Expenses by Mission Category, Tax Year 2011**

Mission category	Number of filers	Percent of filers	Total expenses (in millions)	Program service expenses (in millions)	Percent of total expenses	Management and general expenses (in millions)	Percent of total expenses	Fundraising expenses (in millions)	Percent of total expenses
Arts, culture, and humanities	15,307	8.1	27,747	22,145	79.8	4,078	14.7	1,524	5.5
Education	29,632	15.6	296,473	255,998	86.3	35,038	11.8	5,437	1.8
Environment and animals	8,407	4.4	14,231	11,921	83.8	1,549	10.9	761	5.3
Health	28,122	14.8	902,044	784,358	87.0	114,800	12.7	2,886	0.3
Human services	77,860	41.1	206,744	181,883	88.0	21,616	10.5	3,245	1.6
International and foreign affairs	3,146	1.7	25,033	22,189	88.6	1,934	7.7	910	3.6
Public and social benefit	17,789	9.4	68,515	59,409	86.7	7,450	10.9	1,656	2.4
Religion-related	8,591	4.5	7,900	6,509	82.4	994	12.6	397	5.0
Mutual and membership benefit	579	0.3	2,333	2,199	94.2	130	5.6	4	0.2
<b>Total</b>	<b>189,433</b>	<b>100.0</b>	<b>1,551,119</b>	<b>1,346,696</b>	<b>86.8</b>	<b>187,604</b>	<b>12.1</b>	<b>16,819</b>	<b>1.1</b>

Source: GAO analysis of SOI data from Forms 990. | GAO-15-164

Note: All percent estimates have 95 percent confidence intervals that are within +/- 2 percentage points of the estimate itself. We excluded a very small sample of unknown or unclassified charitable organization filers from our analysis. Therefore, the amounts may not equal the total due to this exclusion and to rounding. Total expenses broken out by program service expenses, management and general expenses, and fundraising expenses are only reported on the Form 990. Therefore, this table does not include Form 990-EZ filers.

# Appendix IV: Comments from the Internal Revenue Service



DEPUTY COMMISSIONER

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

December 4, 2014

James R. McTigue, Jr.  
Director, Tax Issues  
United States Government Accountability Office  
441 G Street, NW  
Washington, DC 20548

Dear Mr. McTigue:

Thank you for the opportunity to review the draft report of the Government Accountability Office entitled "Tax Exempt Organizations: Better Compliance Indicators and Data and More Collaboration with State Regulators Would Strengthen Oversight of Charitable Organizations" (GAO-15-164, JC 451102). The recommendations in the draft report focus on the development of compliance goals for the charitable sector and performance measures that the IRS can use to assess and improve compliance. The draft report also recommends that the IRS continue to work with Treasury officials and state charity regulators regarding the ability to share, protect, and use taxpayer data in the oversight of the charitable sector. We provided technical corrections and comments to the draft report under separate cover.

We appreciate your acknowledgment that the IRS Exempt Organizations (EO) Division has in recent years been operating in a challenging environment in which budgets and staffing have decreased while the number of organizations applying for and obtaining recognition of tax-exempt status has increased. Despite these challenges, EO has worked diligently at the complex and sensitive task of overseeing and regulating the tax-exempt sector.

In FY 2014, EO developed new processes and tools to improve the application process for exempt organizations and reduce the substantial backlog of applications that had accrued in recent years due, in part, to the receipt of applications for reinstatement from organizations whose status was revoked pursuant to the automatic revocation law enacted by the Pension Protection Act of 2006. Starting in April 2014, EO put in place a streamlined process that simplified and accelerated handling of all applications. We assigned and trained additional tax examiners from the Tax-Exempt/Government Entities (TE/GE) and Wage & Investment (W&I) business operating divisions to help process the backlog of applications, and issued Interim Guidance to formalize new instructions and bring clarity to the process. In July 2014, EO debuted the Form 1023-EZ, a streamlined application for recognition of exemption under section 501(c)(3) of the Internal Revenue Code (IRC) available for use by certain smaller organizations. Using these improved processes and tools, EO succeeded in reducing the inventory of cases

that were more than 270 days old by 91 percent, from 54,564 to 4,791. Further, EO closed more than 117,000 application cases in fiscal year 2014, 120 percent over the previous year's total closings. These results represent a significant positive impact on our service to tax-exempt organizations.

EO recognizes the importance of continuing to promote compliance while making these improvements to the efficiency of the determinations process. To that end, EO is undertaking pre- and post-determination reviews of a statistically valid random sample of the organizations that applied for and received recognition of tax-exempt status under these new initiatives to assess and promote compliance by these organizations.

EO recognizes the value of results-oriented goals and related performance measures for purposes of promoting compliance through the examination function that are described in the draft report. To that end, EO continues to refine its compliance strategy and approach to better identify compliance priorities and to determine the effect of enforcement actions on compliance by tax-exempt organizations, including charitable organizations. We are focused on using a data-driven approach to identify and mitigate compliance risks. As you observed, more than 20 percent of charitable organization exams in 2013 came from Form 990 data analytics. Moreover, we intend to rely more on data-mining queries based on the redesigned Form 990 to detect high-risk areas of noncompliance and prioritize enforcement efforts.

The efficient use of data analytics is at the heart of a risk-based approach to compliance, which is now the focus of EO examination efforts. Since July 1, 2014, approximately 50 percent of the applicants that sought exempt status as a 501(c)(3) organization filed a Form 1023-EZ. As described above, for these smaller tax-exempt organizations, we are focused on selecting cases for audit, and assessing and promoting compliance, through the use of statistically valid random samples. This process will take the form of correspondence audits similar to what is currently in use for examination of organizations that received exemption under the streamlined processes debuted in April. With respect to larger organizations, EO is focused on utilizing data to select cases using an issues-based approach that takes into account the potential risk of non-compliance. This has not always been EO's approach. Previously, EO's exam work plan consisted of projects based on market segments rather than a data-driven, risk-based approach. As discussed in the following paragraph, an approach based on standardized types of taxpayers is not the optimal use of resources, and the compliance results cannot be extrapolated to the entire charitable sector.

The National Research Program (NRP) studied the Federal returns of identified types of taxpayers with respect to comparable tax issues. Form 990-series returns are filed by large, well-funded charities that undertake complex and numerous activities, such as universities, as well as smaller, less endowed charities that focus on single activities, such as soup kitchens, and myriad organizations in between. Moreover, their tax

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characteristics and compliance issues may have little in common. Given the discrete populations of taxpayers under IRC § 501(c)(3), an NRP-type study may not be well-suited for analyzing this sector, would require a considerable investment of resources and may not be the best use of our limited resources. However, we agree that having data that inform us as to the levels and risk of compliance by exempt organizations is important. We will continue to explore and develop methodologies that will provide us this information.

You recognized our efforts to collaborate with different federal and state entities, including the Department of Justice (DOJ) and state charity regulators to oversee charitable organizations. You also recognized that there are statutorily imposed requirements to safeguard and limit the use of the taxpayer information that is shared with state charity regulators. Penalties may apply to violations of these restrictions. The National Association of State Charity Officials (NASCO) has credited the IRS with trying to educate state regulators about these requirements. Despite these efforts, we recognize that uncertainty remains, and we will continue our educational efforts and outreach to improve the efficiency with which taxpayer information may be shared with and used by state charity regulators in appropriate cases. In general, the applicable rules already may be in place for State tax agencies as reflected in IRS Publication 1075, *Tax Information Security Guidelines for Federal, State and Local Agencies: Safeguards for Protecting Federal Tax Returns and Return Information*.

The IRS is committed to ensuring that we continue to review and improve all our efforts to maintain appropriate oversight of, and promote compliance by, the tax-exempt sector, including in particular the determination and examination processes described in the draft report. We appreciate having had the opportunity to review and comment on the draft report. Responses to your specific recommendations are enclosed. If you have questions, please contact me, or a member of your staff may contact Tammy Ripperda, Director, Exempt Organizations, at (513) 263-5800.

Sincerely,



John M. Dalrymple

Deputy Commissioner for Services and Enforcement

Enclosure

Enclosure

**GAO Recommendations and IRS Responses to GAO Draft Report  
Tax Exempt Organizations: Better Compliance Indicators and Data and More  
Collaboration with State Regulators Would Strengthen Oversight of Charitable  
Organizations**

To improve oversight of charitable organizations, we recommend that the Commissioner of Internal Revenue take the following steps:

**Recommendation 1:**

Direct EO to develop quantitative, results-oriented compliance goals and additional performance measures and indicators that can be used to assess impact of exams and other enforcement activities on compliance.

**Comment:** We will continue to develop data-driven and risk-based compliance goals, measures, and indicators to focus our exam and other compliance activities.

**Recommendation 2:**

Continue to work with Treasury officials to review the flexibility afforded under PPA consistent with statutory protections of taxpayer data and clarify what flexibility state regulators have in how they protect and use federal tax data, and make modifications to guidance, policies, or regulations as warranted and clearly communicate this information with state charity regulators.

**Comment:** We will continue to comply with IRC § 6104(c), as amended by the charity reform subtitle of the Pension Protection Act of 2006, in keeping with our long-term commitment to proper information-sharing and cooperative regulation with State agencies. In partnership with responsible officials of the Department of the Treasury and IRS Office of Chief Counsel, we shall discuss ongoing communication, informal guidance, and formal rule-making as warranted to clarify pre-existing policies and procedures.



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# Appendix V: GAO Contact and Staff Acknowledgments

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## Contact

James R. McTigue, Jr. (202) 512-9110, [mctiguej@gao.gov](mailto:mctiguej@gao.gov)

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## Staff Acknowledgements

In addition to the contact named above, Kevin Daly, Assistant Director, Jeff Arkin, Sara Daleski, Jillian E. Feirson, Laurie C. King, Lawrence M. Korb, Donna L. Miller, Ed Nannenhorn, Jessica Nierenberg, Karen O'Connor, Dae Park, Amy Radovich, Cynthia Saunders, Albert Sim, Stewart Small, Andrew J. Stephens, Lindsay W. Swenson, Meredith Trauner Moles, Sonya Vartivarian, James R. White, and John Zombro made major contributions to this report.

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