



UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

GENERAL GOVERNMENT
DIVISION

8 JUL 1985

B-217690

Mr. S. Allen Winborne
Assistant Commissioner for Employee
Plans and Exempt Organizations
Internal Revenue Service

Dear Mr. Winborne:

Subject: IRS' Examination Selection System
For Exempt Organizations' Unrelated Business
Income (GAO/GGD-85-64)

We analyzed IRS' current examination selection system for tax-exempt organizations earning unrelated business income (UBI) as part of our overall effort to review IRS' tax return selection and examination process. Our analysis showed that although IRS assessed over \$41 million in additional tax and penalty upon UBI examinations in fiscal years 1981 through 1983, a substantial number of UBI examinations resulted in little or no additional tax revenue. We also observed that IRS does not have sufficient information on UBI tax noncompliance to fully understand the nature and magnitude of UBI noncompliance and develop profiles of high noncompliant tax-exempt organizations engaging in UBI activity. Without such information, IRS' current selection system cannot routinely focus on high noncompliant tax-exempt UBI organizations. These are organizations which regularly do not properly report UBI earnings or pay UBI tax due.

Because IRS data shows increasing UBI activity, high estimates of tax loss due to UBI nonreporting, and low yield from most of IRS' current UBI examinations, IRS may want to focus more on UBI organizations with a high potential for being non-compliant in addition to assuring that exempt organizations are operating in accordance with their exempt purposes. As a start, IRS could initiate efforts to begin developing, collecting, and analyzing information on UBI tax noncompliance. This information would give IRS an indication of the extent of UBI noncompliance and the perspective needed to develop a process for identifying and examining high noncompliant UBI organizations. More targeting of high noncompliant UBI organizations could aid in generating more revenue, increasing compliance, and result in more effective use of resources.

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BACKGROUND

IRS' responsibility in the tax-exempt area includes recognizing tax-exempt status, monitoring tax-exempt organizations for compliance with IRS' rules and regulations, and assessing taxes on exempt organizations' UBI activities. In general, a tax-exempt organization must pay tax on income generated by activities regularly carried on and which are not substantially related to the organizations' purpose for exemption. As part of IRS' overall responsibility for the tax-exempt area, it must ensure, through the examination process, that organizations earning gross UBI of \$1,000 or more properly report earnings and pay any UBI tax due.

In fulfilling this responsibility, IRS should strive for the best possible UBI examination selection system, one that minimizes the use of scarce examination resources yet maximizes tax revenues. Under IRS' current system, UBI examinations are primarily an adjunct to a routine examination for overall tax-exempt law compliance. This system does not specifically focus on the identification of organizations most in need of UBI examination.

IRS statistics show that the number of tax-exempt organizations reporting UBI activities increased from 11,000 in calendar year 1976 to over 23,000 in 1983. As a result of growing federal deficits and reduced government spending for social services, tax-exempt organizations are being asked to assume a greater share in the funding of those services. Therefore, it is likely that in seeking sources of funds, tax-exempt organizations will continue to increase their UBI activity. In addition to this likelihood, IRS' latest tax-exempt Taxpayer Compliance Measurement Program (TCMP) estimates lost unreported UBI tax revenue in excess of \$15 million annually.

OBJECTIVES, SCOPE, AND METHODOLOGY

The objective of this assignment was to determine the effectiveness with which IRS identifies tax-exempt organizations for UBI examination. We performed detailed work at IRS headquarters and the Brooklyn, New York, district office, a key district in the North-Atlantic Region for tax-exempt organizations. Also, we contacted officials in IRS' North-Atlantic, Mid-Atlantic, Central, Western, and Southwest regions for information on UBI examination initiatives conducted.

To achieve our objective, we reviewed the overall results of 8,850 UBI examinations for fiscal years 1981 through 1983. We also made a detailed analysis of these examinations for fiscal years 1982 and 1983, using IRS' Exempt Organization Accomplishment Master File. We analyzed information on examination time expended, tax adjustments, other changes as a result of examinations, and the range of tax assessed. We also attempted to develop profiles of highly potential UBI organizations, but we curtailed our efforts because of difficulties encountered in obtaining completed examination cases and because of IRS' interest in performing such a project.

We also reviewed IRS' annual UBI examination goals and objectives, national and regional office reports, and correspondence concerning tax compliance to determine whether UBI examination initiatives were implemented. In addition, we discussed examination objectives, UBI tax compliance issues, and the appropriateness of a more focused UBI selection system with IRS' national, regional, and district office officials.

Our work was performed from November 1983 through November 1984 in accordance with generally accepted government auditing standards.

MANY IRS UBI EXAMINATIONS RESULT
IN LITTLE OR NO TAX

We analyzed IRS data on 8,850 UBI tax returns that were examined by IRS in fiscal years 1981 through 1983. Our analysis showed that 4,955 of these returns, or 56 percent, yielded no additional recommended tax; 3,642, or 41 percent, yielded \$4.2 million of the \$41.7 million of additional recommended tax during that period; and 253, or 3 percent, yielded almost 90 percent, or \$37.5 million of the \$41.7 million.

The following table presents the overall results of our analysis of the 253 large yield examinations¹ in relation to the 8,850 returns reviewed. It shows that less than 10 percent of UBI examination staff hours expended resulted in most of the additional tax assessed.

¹IRS examinations resulting in additional recommended tax of \$10,000 or more.

All Exempt Organizations' UBI Examinations				Large Yield Exempt Organizations' UBI Examinations					
<u>Fiscal year</u>	<u>Number of returns</u>	<u>Additional recommended tax (millions)</u>	<u>Staff hours</u>	<u>Number of returns</u>	<u>Percent of all returns each fiscal year</u>	<u>Additional recommended tax (millions)</u>	<u>Percent of total additional recommended tax each fiscal year</u>	<u>Staff hours</u>	<u>Percent of total staff hours each fiscal year</u>
1981	2,832	\$16.0	50,820	76	2.7	\$14.8	92.5	4,459	8.8
1982	3,105	15.0	52,219	91	2.9	13.4	89.3	4,072	7.8
1983	<u>2,913</u>	<u>10.7</u>	<u>45,245</u>	<u>86</u>	3.0	<u>9.3</u>	86.9	<u>4,927</u>	10.9
Total	<u>8,850</u>	<u>\$41.7</u>	<u>148,284</u>	<u>253</u>	2.9	<u>\$37.5</u>	89.9	<u>13,458</u>	9.1

If IRS could have identified and examined those UBI returns having the most potential for noncompliance, it may have been possible to obtain similar amounts or more revenue with less examinations.

We recognize that the primary focus of the Employee Plans and Exempt Operations Division is to assure that tax-exempt organizations comply with all the tax-exempt provisions of the Internal Revenue Code, and not only those provisions which relate to UBI tax revenue. However, in light of the increasing UBI activity and the results of current examination efforts, IRS may want to modify its selection system and consider developing a more targeted approach for selecting highly potential UBI returns. A more targeted approach may also require fewer staff to ensure maximum UBI compliance and possibly permit greater examination coverage to meet overall tax-exempt examination objectives.

The concept of targeting high noncompliant UBI organizations is not new to IRS. Special emphasis on UBI examinations has been periodically recommended within IRS. In commenting on tax-exempt examination plans for fiscal years 1981 through 1985, six of the seven regional offices have at one time or another recommended a special emphasis for UBI issues. One region, for each of the years, has suggested that additional resources be applied to two tax-exempt organization categories due to their high potential for UBI revenue. Another region suggested for the 1982 plan that UBI examinations be handled as a separate program "rather than solely as an adjunct to the examination of a tax-exempt organization's informational return." During IRS' most recent effort in fiscal years 1983 and 1984, one region did some targeting of social clubs for UBI issues; of the 500 organizations identified, 136 did not file UBI returns and owed approximately \$75,000 in taxes, and 27 did file but owed \$55,000 in additional taxes.

We recognize that some targeting of high noncompliant returns can be achieved on the basis of available localized information and experience in the area. But to fully realize the benefits of targeting, IRS will need to identify, collect, and analyze UBI data on a systemwide basis. This broad-based information could provide IRS with better insight into the overall magnitude of UBI noncompliance and the nature of tax-exempt activities causing this noncompliance.

INFORMATION NEEDED ON
UBI TAX NONCOMPLIANCE

Much of IRS' current UBI examination information is categorized primarily in terms of whether a "change or no change" was made to the return as a result of examination. A change can represent an adjustment to the reported tax liability or to other reporting requirements having no tax consequences, such as filing an incomplete return. While this information may be useful for other purposes, it does not facilitate identifying and profiling highly noncompliant UBI organizations.

To adequately identify and profile noncompliant UBI organizations, IRS could systematically collect and analyze UBI tax information in such a manner as to provide insight into (1) the extent of tax noncompliance as a proportion of overall activity; (2) whether the tax noncompliance results from overstating expenses, underreporting income, or nonreporting income; and (3) the characteristics of organizations and business activities generating UBI. This information could be very helpful in identifying cases with the most potential for UBI examination by indicating the nature of the noncompliance problem and the types of activities that are prone to noncompliance.

IRS is starting to collect information on UBI activities. The current tax-exempt TCMP, for example, collected UBI data for various tax-exempt organization categories by tax voluntarily reported, tax assessed upon examination, and the activity generating the UBI. This TCMP also shows variances in compliance levels among certain categories of tax-exempt organizations. For example, the rate of compliance for UBI tax measured in dollars for social welfare organizations is estimated at 75 percent, while the rate for charitable and educational organizations is estimated at 42 percent and 39 percent for business leagues. This type of information is helpful because it highlights certain tax-exempt organization categories with low UBI tax compliance levels.

CONCLUSIONS

These efforts to collect and analyze UBI information on various categories of tax-exempt organizations are a start toward better understanding the magnitude of UBI tax noncompliance and developing a strategy to identify and target the most noncompliant organizations. However, due to increasing UBI activity and the results of current examination efforts, a greater understanding of UBI tax noncompliance is needed to

develop a more targeted selection system. Such an understanding could help IRS to better identify the major areas of noncompliance, develop profiles of noncompliant UBI organizations, and establish criteria for selecting UBI returns in most need of examination.

RECOMMENDATIONS TO THE ASSISTANT
COMMISSIONER OF INTERNAL REVENUE

We recommend that the Assistant Commissioner of Internal Revenue for Employee Plans and Exempt Organizations further analyze existing data on UBI tax examinations to gain increased insight into the nature and magnitude of UBI noncompliance. Further, to more completely understand UBI tax noncompliance and to better focus on high noncompliant organizations, we also recommend that information on all types of UBI organizations and specific UBI activities be developed, collected, and analyzed.

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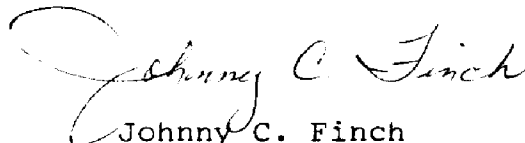
We discussed these matters with officials in the Employee Plans and Exempt Operations Division and provided them with a draft of this report for review and comment. We incorporated their comments in this report. These officials agreed that more could be done to improve the selection and examination of UBI returns. They recognized the possible benefits of developing a UBI examination and selection system which could focus on organizations with high potential for being noncompliant and believe such a system could be cost effective. They advised us that they would be working toward the development of information to facilitate such a selection system. The officials advised us that a future TCMP is being considered to develop more refined selection procedures for UBI examinations and to collect specific information on all UBI activities and aspects of noncompliance. If this TCMP is implemented, its results would be available in 1988 or later. Once this information is collected and analyzed, IRS would be in a better position to fully implement a selection system to focus on UBI organizations with a high potential for noncompliance.

We would appreciate being informed when any future initiatives are undertaken to provide detailed information on UBI noncompliance as well as any efforts to develop a selection and examination system to identify and target highly

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noncompliant tax-exempt organizations engaging in UBI activity. We appreciate the courtesy and cooperation extended to us by your headquarters, regional, and district staff.

Sincerely yours,

A handwritten signature in cursive script that reads "Johnny C. Finch". The signature is written in dark ink and is positioned above the typed name and title.

Johnny C. Finch
Senior Associate Director