United States General Accounting Office

GAO

Report to the Honorable
Fred T. Goldberg, Jr., Commissioner of
Internal Revenue

June 1990

TAX ADMINISTRATION

IRS Can Improve Its Process for Recognizing Tax-Exempt Organizations

GAO/GGD-90-55

GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-238929

June 8, 1990

The Honorable Fred T. Goldberg, Jr.
Commissioner, Internal Revenue Service

Dear Mr. Goldberg:

The Internal Revenue Service (IRS) receives over 50,000 requests annually for recognition of tax-exempt status under Section 501(c) of the Internal Revenue Code and had recognized over 1.2 million tax-exempt organizations by the end of fiscal year 1989. Section 501(c) contains 25 categories of tax-exempt organizations, including those organized for charitable, educational, religious, and social welfare purposes. IRS' tax-exempt determination process is designed to ensure that tax-exempt organizations operate for the purposes specified in Section 501(c).

IRS officials have noted that most tax-exempt organization compliance problems identified by IRS subsequent to a determination could not have been found during the determination process. Because many of the organizations requesting exemption are new or have had limited activity, a determination is often based on proposed activities. Therefore, IRS cannot determine whether an organization is operating for an exempt purpose until it examines data reported on an annual information return filed by the organization. Recognizing the value of expediting the determination process to make more resources available for examinations, IRS authorized an expedited process beginning in October 1987.

IRS planned to use over 30 percent of the direct staff time it devoted to exempt organizations in fiscal year 1989 for the determination process. Therefore, this process has a great impact on the resources available for examinations of tax-exempt organizations. A more efficient and effective use of resources in the determination process could ultimately allow more resources to be devoted to the examination process. Our objective was to review the determination process, including the use and impact of expedited determinations.

Results in Brief

Our work showed that IRS could take several administrative actions to better use its resources and improve efficiency. We found that usage of the expedited determination process during fiscal year 1989 varied among the seven district offices responsible for exempt organization matters, ranging from 17 percent of determination requests in one district to 2 percent in another. While IRS has encouraged the use of the process, an absence of clear guidance has resulted in confusion among

the district offices as to when the process can be used and variation among the districts in the types of determinations for which the process is used. As a result, IRS may not be making the most efficient and effective use of its resources through optimum use of the expedited process.

We also observed that IRS does not use its determination resources most effectively when doing advance ruling follow-ups. Advance ruling follow-ups are performed 5 years after the initial determination to properly classify a Section 501(c)(3) organization as a public charity or private foundation; private foundations are subject to more stringent regulation. The effectiveness of advance ruling follow-ups is limited because they do not include a review of expenditure data. Such a review could provide IRS with greater insight into whether organizations are operating in accordance with their stated tax-exempt purposes.

Finally, we found that IRS procedures to close cases for lack of information create inefficiencies. Cases closed because they lack sufficient information to make a determination are often reopened because the applicant organization subsequently provides the requested information. Inefficiencies and delays in responding to the applicant organization often result when a case is reopened, because these cases must be administratively reestablished.

Background

The Internal Revenue Code grants tax-exempt status to any organization qualifying for one of 25 types of exemption under Section 501(c). Most organizations apply to IRS for exempt status by filing an application with the IRS Exempt Organization (EO) district in which their principal place of business is located. Organizations must also report subsequent organizational and operational changes to the EO district office. Section 501(c)(3) organizations, such as educational, historical, or charitable organizations, are classified as (1) private foundations or (2) public charities, which are publicly supported or are operated to benefit publicly supported organizations. This classification is important because private foundations are subject to a variety of taxes, requirements, and penalties.

When applying for recognition of tax-exempt status under Section 501(c)(3), new organizations must indicate whether they expect to be a private foundation or a public charity. Some organizations, such as churches, educational organizations, and hospitals, may be statutorily exempted from classification as a private foundation. Other organizations that can reasonably be expected to be publicly supported can

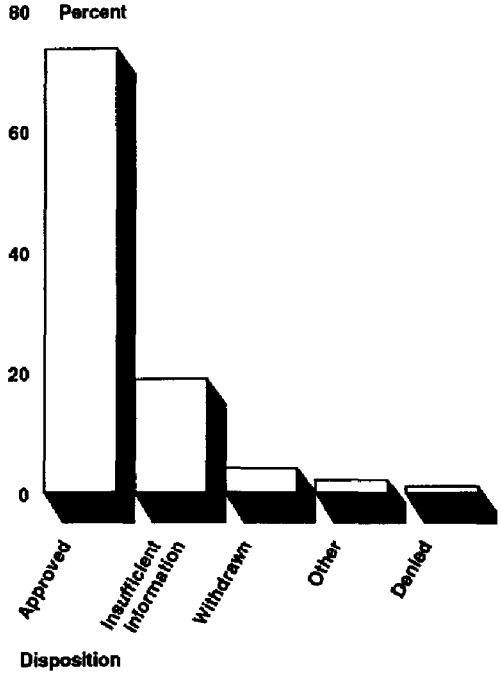
receive an advance ruling treating them as public charities for 5 years. At the end of the advance ruling period, these organizations must submit annual income data for the 5 years so IRS can make a final determination of their foundation classification. This determination is called an advance ruling follow-up. For fiscal year 1988, IRS estimates that 77 percent of all determination requests were for 501(c)(3) status and that the majority of these will receive an advance ruling follow-up.

During the determination process, IRS must judge whether an organization is organized for and is or will be operating for purposes compatible with those specified in the 501(c) section under which it seeks tax-exempt determination. The application must be accompanied by copies of the organization's certificate of incorporation, the current by-laws, a statement of receipts and expenditures, and a balance sheet for the current and 3 preceding years, if applicable. Because many organizations have little or no actual activity at the time they apply, the determination often is based on proposed activities and estimated revenues and expenditures.

Once an organization has received tax-exempt recognition, IRS can review reported activity and financial data to ensure compliance with legal requirements for tax-exempt status during examinations of annual information returns (Form 990, "Return of Organization Exempt from Income Tax") filed by the organization or during the advance ruling follow-up. However, for many tax-exempt organizations, the advance ruling follow-up may be IRS' only opportunity to review the reported results of operations. Many tax-exempt organizations are not required to file information returns because their annual gross receipts are less than $25,000 and, therefore, would not normally be selected for examination. IRS estimates that for fiscal year 1988, approximately 60 percent of all tax-exempt organizations were not required to file a Form 990. Further, IRS examines only a small percentage of those organizations that file information returns. For example, IRS estimates that it has examined only 1.4 percent of those organizations that filed returns for fiscal year 1985, the latest year for which examination information is available.

In fiscal year 1988, IRS devoted approximately 33 percent of its EO direct staff time to determinations. During this same period, IRS received over 54,000 requests for exempt status and disposed of over 56,000. As shown in figure 1, 74 percent of requests were approved, and 1 percent were denied. Determinations were not made for the other 25 percent, most often because IRS was not provided sufficient information.

Figure 1: Disposition of Determinations in Fiscal Year 1988



IRS has given the processing of determination requests priority among EO activities. As a result, the resources available for examinations and other EO activities are directly affected by how efficiently determination requests are processed.

The expedited determination process was initiated to make the determination process more efficient. The expedited process is the reviewing of determination requests by an experienced employee who decides which applications can be disposed of quickly without further review by a specialist or contact with the taxpayer. For those requests that cannot be disposed of quickly, the employee notes the issues needing further consideration before the requests are assigned to specialists. While expedited requests are disposed of in about 1/2 hour, it can take 3 hours or more to dispose of requests assigned to specialists. The expedited process can also reduce the time needed by specialists because the initial reviewer identifies the issues to be considered by the specialists.

Objectives, Scope, and Methodology

Our objective was to examine the efficiency and effectiveness of the determination process, including the use and impact of expedited determinations.

To accomplish our objective, we

- obtained and analyzed policies and procedures governing the determination process, to understand the key issues to be addressed in a determination;
- analyzed IRS statistics on the number of determination requests processed and resources expended from fiscal years 1986 through 1988, to understand the magnitude of the determination process;
- analyzed available IRS studies on the use of an expedited determination process, to identify benefits of and concerns about the process;
- talked to IRS officials in the Assistant Commissioner's office, the EO Determinations Branch, and the seven EO district offices responsible for exempt organization matters, to further identify concerns about the determination process; and
- visited the Brooklyn, Chicago, and Baltimore districts and analyzed a total of 143 recent determination dispositions collected for us by IRS, to better understand how the process works.

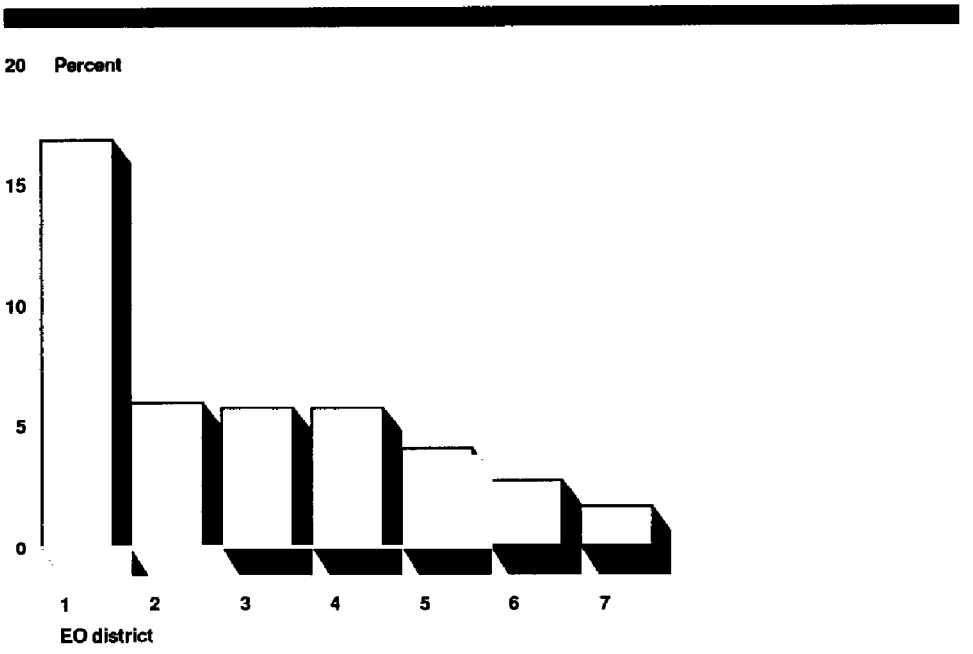
We obtained written comments from the Assistant Commissioner Employee Plans and Exempt Organizations (EP/EO) on a draft of this report. These comments, received in a letter dated March 27, 1990, are included in appendix I and are summarized and incorporated in the report where appropriate. We did our work from May 1989 through October 1989, using generally accepted government auditing standards.

The Expedited Determination Program Needs More Guidance and Evaluation

IRS may not be realizing maximum benefit from its expedited determination process. IRS recognized the potential benefits of the process when it agreed to test the process in one district in November 1986. The test results were favorable and the process was authorized for use nationwide in October 1987. Although IRS has encouraged its use as the most effective means of allocating determination time and resources, use of the expedited process has been voluntary and its use has not been evaluated. Consequently, the EO districts vary in their decisions as to when they use the process and the types of determinations that they expedite. As figure 2 shows, all EO district offices used the expedited process to some degree during fiscal year 1989, the first year for which national statistics are available. However, in fiscal year 1989 usage varied from

17 percent of determination cases in one district to only 2 percent in another.

Figure 2: EO District Office Use of the Expedited Determination Process



The National Office regards the expedited process as applicable to any type of organization historically demonstrating high levels of compliance, such as garden clubs, but its guidance does not specify which types of organizations it regards as such. It only specifies categories of organizations, such as churches and schools, for which the process cannot be used due to the complexity of issues generally found in these cases. As a result, district officials were uncertain about which determinations could be expedited. For example, while an official in one district told us that advance ruling follow-ups could not be expedited, such cases were the ones most frequently expedited in three other districts. Some EO district officials, in order to improve their own use of the process, would like a national evaluation of this process to learn the nature and extent of other districts' use of it.

In addition, failure to adhere to the guidance that does exist has resulted in variations in the use of the expedited process. While guidance on the process prohibits expediting applications that are clerically incomplete

or considered sensitive, one district was expediting incomplete applications, and another was doing so for what IRS considered potentially sensitive cases. Still another district gave managers discretion to expedite determination requests even though the requests initially were not considered appropriate for this process under current guidance.

Conclusion and Recommendation

Given the lack of clear guidance and the inconsistency in application across the districts, IRS may not be benefiting as much as it could from the expedited determination process. Accordingly, we recommend that you direct the Assistant Commissioner (EP/EO) to (1) evaluate the current use of the expedited determination process, as a basis for developing a national program that will include clear guidance on when the process is to be used, and (2) assess the possibility of redirecting resources between determinations and examinations as increased use of the expedited determination process results in more efficient use of determination resources.

Agency Comments and Our Evaluation

IRS said that it has encouraged the use of the expedited determination process and has given the districts much leeway in implementing the process. IRS agreed that it is time to consider evaluating the process and that it might develop program guidance after such an evaluation. We believe that after an evaluation of the use of the process, IRS should develop program guidance.

Advance Ruling Follow-Ups Could Be More Effective

Advance ruling follow-ups could better help IRS ensure that tax-exempt organizations are complying with the requirements for their tax-exempt status. Currently, the advance ruling follow-up process is only used to classify Section 501(c)(3) exempt organizations as private foundations or public charities on the basis of the amount of public support received during the advance ruling period. Essentially, IRS does a mathematical computation using information from a statement of income sources submitted by the organization. Consideration is not given to how the organization is using its income or the extent to which it is fulfilling its exempt

purpose. Review of expenditure data as well as revenue data could provide IRS insight into whether the organization is fulfilling its exempt purpose and whether there are other potential issues, such as private inurement or unreported unrelated business income.[1]

We reviewed a sample of 31 advance ruling follow-ups collected for us by IRS during which IRS had used only revenue information to classify organizations as private foundations or public charities. We found, and IRS agreed, that in 13 of the cases, more information about receipts and information about expenditures were needed to resolve questionable matters, such as how exempt purposes were being met and whether there was private inurement. For example, one organization's initial application projected that annual receipts would be in excess of $300,000. Actual receipts averaged less than $20,000, almost 40 percent of which was from an income source not originally planned and could have been unrelated business income. In addition, questionable expenses that were first disclosed in the initial application were not examined as part of the initial determination or the advance ruling follow-up. Information needed to examine these receipts and expenses was not requested.

If organizations were required to provide both income and expenditure data for advance ruling follow-ups, IRS would be able to make better assessments of whether they are operating in accordance with their tax-exempt purpose. Expanding the advance ruling follow-up form to include expenditure data or submitting the annual information return currently required of organizations with gross receipts of $25,000 or more could provide much of the necessary data.

Conclusion and Recommendation

IRS presently considers only revenue data in following up on its advance rulings for tax-exempt status. To better ensure compliance with tax-exempt status requirements, we recommend that you direct the Assistant Commissioner (EP/EO) to obtain and analyze both expenditure and revenue data during the advance ruling follow-up process.

[1]Private inurement refers to the prohibited situation in which certain inside individuals, such as trustees, officers, members, founders, or contributors, receive net earnings of an exempt organization, except as reasonable payment for goods and services. Unrelated business income is the income generated by an exempt organization from conducting any trade or business substantially unrelated to the purpose that qualified the organization for exempt status. Exempt organizations that earn annual unrelated business income in excess of $1,000 must report the income to IRS on Form 990-T and pay tax on it.

Agency Comments and Our Evaluation

IRS officials agreed that expenditure data would provide them more information to measure compliance by tax-exempt organizations. However, they expressed concern about the burden providing such information might create for some organizations and were unsure of the benefits to be derived. They did agree to consider the recommendation, and may attempt a test in selected districts to determine the benefits that could be derived.

Considering the fact that many organizations must currently submit income data for an advance ruling follow-up, we question whether submitting expenditure data would add a significant burden, particularly for those organizations that currently file annual information returns. These returns already include data on expenditures. Further, we believe that this new reporting requirement would help IRS gain better insight on the extent of noncompliance. Accordingly, we believe that as a minimum, IRS should test the costs and benefits of obtaining and analyzing expenditure data.

Determination Case Closings Could Be More Efficient

Often, IRS must request additional information before determining that an organization meets the requirements for exemption. Generally, the organization is given up to 35 days to either submit the requested information or request an extension. If the organization does not respond within the 35-day period, the case is closed and removed from inventory. Approximately 19 percent of all determinations for fiscal year 1988 were closed because of insufficient information. If the needed information is submitted at a later date, a new case is established in inventory.

The number of cases closed because of insufficient information and subsequently reopened is not monitored. However, available IRS statistics show that 5 percent of all determinations in fiscal year 1988 were reopened cases. We reviewed 35 cases that were closed because of insufficient information. These cases were collected for us by IRS in two districts. Our review disclosed that the information was subsequently received and the cases were reopened in 25 of these cases. In two other cases, the organizations had initiated action to provide the requested information. For 11 of the 25 reopened cases, the requested information was received within 1 month of closing, and in 20 of the 25 cases it was received within 3 months.

When a case previously closed for insufficient information is reopened, it must be administratively reestablished in inventory, the case file must

be retrieved, and it must be reassigned to the specialist. This process often creates delays in responding to the taxpayer and results in unnecessary technical and processing work. For example, 16 of the 25 reopened cases were not reopened and processed until the month after the information was received. Additionally, 11 of the 25 cases were reassigned to a specialist other than the one who had previously worked the case. While cases are normally assigned to the same specialist, IRS officials said that this was not always possible because the initial specialist might be unavailable due to training, reassignment, or heavy work load. Reassignment to a new specialist creates inefficiencies because the newly assigned specialist has to become familiar with the details of the case.

Agency Comments and Our Evaluation

IRS agreed that cases may too often be closed prematurely because of insufficient information and that unnecessary closing and reopening of cases causes inefficiencies. IRS said that, as a result of its own concerns about closing procedures for cases with insufficient information, revised case closing procedures were issued in December 1989 after the completion of our fieldwork. These procedures allow an extension of the 35-day waiting period when the organization notifies IRS that it is assembling the requested information. We believe these procedures should reduce the inefficiencies currently created from the frequent closing and subsequent reopening of cases.

As you know, 31 U.S.C. 720 requires the head of a federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than 60 days after the date of the report. A written statement must also be submitted to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the Director, Office of Management and Budget, the Secretary of the Treasury, and interested congressional committees. We will make copies available to others upon request.

We appreciated the support and cooperation of your staff during this work. Major contributors to this report are listed in appendix II. Please contact me at 272-7904 if you or your staff have any questions concerning this report.

Sincerely yours,

Paul L. Posner

Paul L. Posner
Associate Director, Tax Policy and
Administration Issues

Contents

Abbreviations

EO	exempt organization
EP/EO	employee plans and exempt organizations
IRS	Internal Revenue Service

Comments From the Internal Revenue Service

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

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

ASSISTANT COMMISSIONER
(EMPLOYEE PLANS AND
EXEMPT ORGANIZATIONS)

MAR 27 1990

Mr. Paul Posner
U.S. General Accounting Office
Associate Director for GGD Tax Group
1440 New York Ave., N.W.
Suite 400
Washington, DC 20005

Dear Mr. Posner:

This is in response to your draft report entitled Tax Administration: IRS Can Improve the Determination Process for Tax-Exempt Organizations. A copy of this report was informally provided to us by a member of your staff on March 14, 1990.

Your report makes three recommendations regarding the Exempt Organizations' determination program. The first addresses the expedited determination process (also known as the technical screening program) and recommends that the National Office: (1) evaluate the current use of the process as a basis for developing a national program that will include guidance on when technical screening is to be used; and, (2) assess the possibility of redirecting resources between determinations and examinations as increased use of technical screening results in more efficient use of determination resources.

The second recommendation concerns advance ruling follow-ups of initial IRC 501(c)(3) public charity determinations. It recommends that, to better insure compliance with the requirements for tax exemption, advance ruling follow-ups include a review of expenditure data (in addition to the revenue data currently required).

See comment 1.

The third recommendation concerns the so-called "failure to establish" procedures regarding those determination cases closed because of a lack of sufficient information to make a determination. It recommends that the data on cases closed under these procedures, and then later reopened, be reviewed in order to establish an appropriate time frame for holding cases open where the Service has insufficient information to make a determination.

After review of your recommendations we have several comments about them, particularly in regard to the background information (which were shared with members of the audit team in a meeting held on March 21, 1990).

Mr. Paul Posner

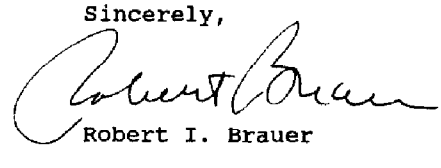
In regard to the expedited determination process, we wish to note that the program is still relatively new (having been implemented nationwide in FY 1989). In addition, since the program was started, and continuing to present, the key district offices have been allowed much leeway in how they use this process in order to permit the development of innovative techniques and applications. Since it is a relatively new process, no national evaluation of it has been done, although we are now at the point where one is being considered. It should be noted that we have overseen the technical screening operations of the individual key district offices in order to monitor their progress. We have encouraged the use of this process and have offered suggestions on it to the key district offices, and we contemplate issuing program guidelines once a national evaluation has been completed.

Concerning the expansion of the use of the advance ruling follow-ups to include expenditure data, we have reservations about this. Our primary concern is the burden that this will impose on taxpayers, as well as the resources it will cost the Service. We also are not sure of the benefits that will be derived from this. However, we will consider this matter further and may attempt a test of it at one or more key district offices in order to determine its benefits.

Finally, regarding the "failure to establish" procedures, because of our own concerns in this area, in July 1989 we issued guidance to our field offices for development of their FY 1990 workplans. We indicated that "the effect on service to the public and organizational cost of closing cases as "failure to establish" must also be considered. We went on to say "it (the IRM) will recommend holding cases open for a reasonable period when the response is expected in the near future". The IRM was published in December 1989, allowing for an extension of the time period for an organization seeking a determination to supply missing information. In addition, it has always been our policy that determination cases closed for "failure to establish" and then later reopened be assigned to the same specialist, if practicable.

We hope that you will find these comments useful.

Sincerely,



Robert I. Brauer

The following is GAO's comment on the Internal Revenue Service's letter dated March 27, 1990.

GAO Comment

1. Because IRS recently issued guidance on determination case closing procedures, this recommendation has been deleted.

Major Contributors to This Report

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