

Remarks of Steven T. Miller
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Representing and Managing Tax-Exempt Organizations
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I'm happy to be here this morning.

In the last couple of years I have taken a bit of a different approach to these speeches. There are others here from the Internal Revenue Service who are better suited to speak to specific initiatives or guidance. I have tried to use these speeches to raise a few questions, provoke some discussion and some thought. That's what I want to do today too.

Today I want to speak on two topics. The first is an update on part of last year's discussion. I want to talk about a couple of areas over which we have what I would call implicit jurisdiction. These are areas where the Code does not clearly set forth a standard, but where we need to involve ourselves to assure the integrity and compliance of the sector, and the public's confidence in it.

I am talking about some old friends: one is governance, and the other is efficiency and effectiveness. I will speak both to why we need to continue our work in these areas, and what we have done to bridge what otherwise would be gaps in our administration of the tax law.

Then I want to turn to a related but slightly different topic. Over the last several years I have described at this seminar what we see as strategic trends in the tax-exempt sector: complexity, growth and the misuse of exempt organizations, to name a few. These trends reflect our views of the sector from 10,000 feet. What I want to talk about today is more about what is happening on the ground – what I will call the tactical environment in which the Service must operate. I want to show you where TE/GE lives every day. I want to give you a window into the world of a federal regulator. And what a marvelous if odd world it is. In this regard I will talk about section 6103 protections, the enormous diversity of the sector, and the sometimes rusty contents of our enforcement tool box.

But as I often do, I will set the table for both discussions by describing a few salient features of the sector.

In 1998, how many section 501(c)(3) organizations were there? One waived user fee for a correct answer.

There were more than 650,000. Today there are 1.2 million.

In 1998, what were the gross receipts of 501(c)(3)s?

The answer is \$990 billion. Quite a bit of money, but receipts have more than doubled since then.

One last quiz question: What number has not changed over that time span? Our staffing. In fact our staffing has remained fairly constant; at present it is what it was then (although it has bounced around a bit in the meantime).

With that as preface, let's begin. I will start with our jurisdiction. At best it is incomplete. What jurisdiction does the IRS have, what does it not have, and what is somewhere in between?

And this brings up a story involving my daughter. I discuss tax administration and policy with my daughter, and all my best ideas come from her.

So we are in the car and I ask what she believes we should do to police the country's charities. She said, "How about making sure they give money to those people who are worthy?" Her actual words.

I replied, "Well, you know, we can do that, but only sort of around the edges. We can determine whether an organization is benefiting a charitable class – worthy people – and we can make sure they are serving public interests rather than private interests. But we really don't look directly at the quality or quantity of what the organization is providing. Efficiency and effectiveness are not clearly our issue."

Well, by my second sentence, she lost interest, as some of you have, and went back to reading her book, Half Magic, which, by the way, is a great book in which a magic charm grants your wishes, but only half of each wish. So you need to be careful what you ask for. I believe it was written as a fable about our budget process.

Efficiency and effectiveness

But, back to the topic. Efficiency and effectiveness are not expressly within our jurisdiction. This is one of our jurisdictional gaps. But it is an issue of fundamental importance, and one that increasingly is attracting attention. Recently, there were Congressional hearings on veterans' organizations. They were essentially about fundraising efficiency and compensation. It is an issue we cannot ignore if we are to faithfully administer the tax law.

I am not going to speak specifically about the veterans' cases because that is not my point. My point is that the public and the Congress may and often do have an expectation that the Service can act when we see organizations spending 98 cents of every dollar on fundraising or compensation and 2 cents on services.

Now depending on the facts and just how egregious they are, such a situation may present issues of either private benefit or private inurement. But for the most part what we can do about efficiency and effectiveness is what we have been doing lately: pushing transparency so people can see for themselves just how efficient and effective an organization is, or is not. This means we need to give the public tools they can use to make apples-to-apples comparisons. As the public seeks a good “return” on its contribution dollar, we push for enhanced and meaningful transparency in the hope that market forces and the good sense of the public will bring about change.

We have taken a meaningful step in this direction with our work on the redesigned Form 990. One of our guiding principles was to create uniformity and transparency in reporting.

The draft form included some ideas based on the apples-to-apples approach. These included the efficiency indicators we placed on the original summary page – the indicators that fell off the form in the face of strong criticism from the community. People were concerned that putting these indicators on the front page was value-laden and misleading. There were arguments that the indicators would present bad results in situations where they shouldn’t, for example in fundraising. Commentators pointed out that the cost of fundraising for a new organization or for an unpopular cause can legitimately be very high, and high costs in these situations cast a shadow over the organization.

We anticipated some of this, but your comments convinced us that we had not yet found a universal indicator of efficiency or effectiveness. We concluded that the best we can do with the Form 990 for now is to create a climate of transparency.

I have to tell you that I was and remain disappointed by the Service’s and the sector’s current inability to devise one or more shorthand indicators. But I have not given up.

There is a second way to bridge the gap in our jurisdiction over efficiency and effectiveness. I would like to see us re-energize a little-used line of legal precedent.

We have spoken in recent years of using the commensurate test to create and enforce a standard to ensure that organizations spend in line with their resources. Obviously the Senate Finance Committee has been a leader here and is looking at the issue with respect to endowments. We also have led with respect to endowments by requiring reporting on the Form 990.

We will also look at this issue as part of our colleges and universities study later this year. Further, in the next 18 months, EO Director Lois Lerner and her team expect to develop a broader program initiative focusing on the commensurate issue. I believe it is time for the Service to be more aggressive in this area. This is not to say that we should necessarily devise inflexible rules about spending by

all exempt organizations. No one wants the Service dictating how a charity should do its job. But every charity should make responsible and appropriate use of its resources to achieve its charitable purposes. That is what the tax-subsidy is for.

Governance

Let's move on to governance. I discussed this as part of my presentation yesterday, so I will only touch on it here, but it is clear that we have already begun to bridge this jurisdictional gap.

Why do we care? We believe there is a nexus between good governance and tax compliance. It's as simple as that. That belief underlies our work in this area. At the same time, it is clear that there are no specific guideposts in the Internal Revenue Code for governance; there is a gap.

Now some argue correctly that the states pick up a piece of the governance issue, and they do. Others argue that one size does not fit all when one is talking about governance practices, and that is also correct. Still others argue that self-regulation is best, and there is truth in that. But agreeing with all these objections does not change the fact that the Service has a place at the table whenever governance is discussed. Arguments to the contrary, as I tell my staff, are now beside the point. We are past them. Let me speak instead to where we are going with governance.

First, the Service must educate. It's true that one size of governance does not fit all exempt organizations, but that does not mean that we should not advance and promote principles of good governance that fit many organizations very nicely and that can be tailored to suit the needs of most organizations.

Second, the crown jewel of our work on governance is clearly the redesigned Form 990 and its new governance section. Transparency is important for good governance, just as it is for efficiency and effectiveness. It is indispensable – the foundation for our other efforts.

We have been saying that good governance is a leading indicator of good tax compliance. In reply, some say: "Prove it." We are going to try. It seems like a logical inference, but it's reasonable to test the point.

Lois and her team are developing projects to do just that. One suggestion that I think we will pursue is for agents to ask themselves a set of questions at the end of the exam of an exempt organization. Did we uncover a problem that was the result of a governance weakness? Or would the problem we found have been discovered and corrected without us if appropriate governance structures had been in place? Are there actions the organization can take going forward that will help it stay in compliance?

Some of this already is being done. But a post-exam checklist, used systematically, might give us a better feel for the impact of governance in our

area, and we would publicly report what we find. This would appear to be the next natural extension of our work in the governance area. You should expect to see other projects based on our analysis of data from the new 990 as well.

Let's talk about the second topic today. I want to give you a window into my world and discuss the tactical enforcement environment.

First is section 6103, which gives rise to an environmental factor that I call the public/private paradox. Now there are good policy reasons for section 6103. Our entire tax system relies on the trust people have that their tax information will be private. Understand that I am not suggesting any modification here. But I do want to talk about what impact it has on TE/GE.

So what is the public/private paradox? It is this: the section 6103 requirement that the IRS protect taxpayer information can create imbalances in the public's picture of our enforcement efforts. The paradox stems from the very public nature of questionable behavior and filings by tax-exempt organizations versus the very private nature of our enforcement efforts.

Problems with respect to a charity or other nonprofit can become exceptionally public. Yet we cannot make our response public, unless the taxpayer consents. In most cases, our enforcement actions and even the final disposition of a case are shielded from public view.

This leads to all kinds of misperceptions about what the Service is or is not doing.

Our statutorily required reticence can lead the public to think that we are failing to act in a case that cries out for action, or that we are harassing some poor taxpayer, or treating an organization unfairly, or that we are just incompetent. It also leads to a lot of "no comments" to reporters' questions. None of this aids us in our relations with our stakeholders.

The second tactical environmental factor is the very diversity of the sector. This is, of course, a great asset of the sector, but it is also a complicating factor in achieving effective regulation. Communicating with small organizations about the new e-Postcard, Form 990-N, is very different, for example, from providing guidance on functionally integrated supporting organizations.

This diversity compels us to customize many aspects of our compliance strategy, from what problems we look for to how we deal with issues when we find them. Consider a small veterans' organization with pull-tab gaming, versus a large private foundation engaged in activities around the world. It is hard to be staffed, educated and sufficiently flexible to be responsive to all types and sizes of organizations.

In part because of this tremendous diversity, and the accompanying complexity, we seem always to be behind the sector in understanding the ever-changing markets in which organizations operate, and their innovative ways of raising

money, meeting budgets, and advancing the social good. We need to work on this.

Another tactical environmental factor we encounter is the blunt and sometime inflexible character of our existing enforcement tools. This starts with the determination letter process. This process unquestionably is an important tool. It is our chance to weed out poor candidates for exempt status, and also to educate new exempt organizations. The process is part registration, part education, and part gatekeeper.

But there are competing goals at work here. On one hand, providing good customer service requires us to be expeditious in processing and approving an application for tax exemption. On the other, enforcing the law requires us to take sufficient care to identify those who are trying to game the system, so that we can properly deny their applications.

Moreover, the process has inherent issues. Organizations come to us inchoate. They are just getting started, and we are asked to grant them exemption based on suppositions, intentions and guesstimates. The process is not really built to ferret out all questionable organizations; it is built to get applicants to a favorable result within a reasonable period of time. And as most applicants are trying to do the right thing, it works reasonably well.

But, it is not a process certain to stop clever people with a bad motive from moving into the sector. Yet we do try. Rob Choi, EO's Director of Rulings & Agreements, will tell you about our effort to separate tough cases from the ordinary work stream so we can give questionable applications the careful scrutiny they demand. This happened in the credit counseling and down payment assistance areas, for example. Still, the public clamor for quick service works against the goal of discovering and rejecting unworthy applicants.

We have done some good work here. Lois and her team have created the Review of Operations unit to improve the review process and combat this problem. It is intended in part to take a critical look at organizations that are in their adolescence. Are these young organizations actually engaged in tax-exempt work? Are they doing what they said they would be doing? We are beginning to systematically review groups of organizations that are 3 or 4 years into their operations. These reviews should become a key part of our compliance work, and help us strike the right balance in the determinations process.

The bluntness of some of our enforcement tools also exhibits itself in our examination process. A clear example is revocation of tax-exempt status. Revocation is clearly on the tool belt, but is it really useful in very many cases? Often it is quite a bigger remedy than what is needed – a bulldozer when a shovel from the sandbox will do. So we do not use revocation often. Instead, we move in what are sometimes odd and non-public ways – using closing letter advisories or closing agreements, for example – to restore an organization to

compliance. There is nothing wrong with this; it is a good workaround, but a workaround nonetheless.

In several areas we do have intermediate sanctions. These seem more flexible, but they too can be blunt instruments in some cases and inadequate ones in others. They may or may not be effective or appropriate in a given situation. For example, the excess compensation sanction hits the individual insider but not the organization, and allows for some salaries which may shock the public conscience, due to the permissible use of salaries from the for-profit sector as comparables. The public is disturbed, and sometimes outraged, by enormous executive salaries that mirror those in the for-profit world, but the Service must apply the law as it exists.

With respect to political activities by a charity, we have section 4955. This is based on a difficult-to-calculate, and often not particularly relevant, expenditure-based sanction. If you wish to understand what I am referring to, think about the rather minimal actual costs an organization is likely to incur if it permits someone to deliver a political speech during one of its events.

And I should say with respect to all the tools I am discussing, workarounds exist but perfection never will. I am not arguing for revisions of the Code. Again, all I am trying to do here is give you an inside look at our world.

Reasons for optimism

Let me wind up. Both pieces of my discussion address how we react to important challenges. First, how we make progress in the areas of good governance and efficiency and effectiveness in the absence of an explicit statutory mandate. Second, how the tactical environment impacts our ability to promote compliance and administer the law.

I've noted that we have had difficulties addressing areas that the public believes we should address. And we are at a disadvantage in communicating our enforcement results; our determination process suffers from conflicting goals; and our tools are not the sharpest in the shed.

Should I pack my toys and go home? No. Notwithstanding the impediments we face – the gaps in our jurisdiction and our tools – we will still be effective. The gaps just mean we need to be creative in our approach.

And I am optimistic about the overall direction of the tax-exempt sector. We have experienced some remarkable developments regarding transparency and good governance over the past few years.

Transparency is on the rise. We will soon be getting vastly better and more pertinent information from the redesigned Form 990. The public will also have access to 990Ts, which is another step towards greater transparency. And I believe that there will be continued activity and progress in the financial reporting

area, including more on FIN 48 and other developing financial reporting requirements.

As to governance, I always come back to the fact that the vast majority of the sector wants to comply. It is the sector's own work in self-regulation that is the greatest contributor to improved governance. The leadership of the tax-exempt sector has demonstrated that this community not only thinks it should be compliant, and wants to be compliant, but has gone to great lengths to be compliant. The same is true with efficiency and effectiveness.

As we look forward, all of these factors point in the same direction. Greater transparency. Better governance. More accountability. Higher standards. And that bodes well for a great future.

Thank you for your attention.