



*A Documented Comprehensive Strategy Is
Needed to Focus Efforts on Ensuring
Compliance by Tax-Exempt Non-filers*

March 31, 2009

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This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

March 31, 2009

MEMORANDUM FOR COMMISSIONER, TAX EXEMPT AND GOVERNMENT ENTITIES
DIVISION

FROM: (for) Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – A Documented Comprehensive Strategy Is
Needed to Focus Efforts on Ensuring Compliance by
Tax-Exempt Non-filers (Audit # 200810021)

This report presents the results of our review of the Internal Revenue Service's (IRS) efforts to identify and address tax-exempt non-filers. The overall objective of this review was to assess the Tax Exempt and Government Entities Division's efforts to effectively address Return of Organization Exempt From Income Tax (Form 990) filing compliance. This audit was conducted as part of the Treasury Inspector General for Tax Administration Office of Audit Fiscal Year 2008 Annual Audit Plan related to the major management challenge of Tax Compliance Initiatives.

Impact on the Taxpayer

Tax-exempt organizations, such as charitable organizations, are generally required to file an annual information return with the IRS. Although the Exempt Organizations function is performing activities to secure delinquent returns, we believe steps could be taken to more fully identify and address non-filers. The filing of required tax-exempt organization returns in a timely manner is critical to increasing the ability of taxpayers to accurately view the operations of tax-exempt organizations. When returns are not filed in a timely manner, taxpayers do not have information about the tax-exempt organization to help make their contribution decisions.



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Synopsis

The Exempt Organizations function within the Tax Exempt and Government Entities Division has taken many actions in its efforts to identify non-filers and obtain delinquent returns. For example, the Exempt Organizations function created the Compliance Strategies Critical Initiative Office to coordinate strategic planning, monitor progress of critical initiatives, and analyze the results of projects. In addition, examinations and other projects that include efforts to identify non-filers and secure returns are routinely initiated.

While the Exempt Organizations function has taken actions that have resulted in obtaining some of the delinquent returns, we believe steps could be taken to more fully identify and address non-filers. To accomplish this, the Exempt Organizations function needs to develop and document a comprehensive non-filer strategy. This strategy could address several areas where we believe current and future efforts should be improved, such as:

- Creating overall program goals and performance measures related to all non-filer efforts – It is difficult to determine the success of current efforts to address non-filing because the Exempt Organizations function has not yet developed overall goals and performance measures related to non-filers. For example, if the Exempt Organizations function was able to determine the voluntary compliance rate for tax-exempt organizations, it could set goals to improve the voluntary compliance rate.
- Establishing plans for conducting analyses of non-filer project results – Exempt Organizations function officials have not analyzed project results for any non-filer related trends. For example, trend analyses could be used to develop education materials and thus help to reduce noncompliance among tax-exempt organizations if the Exempt Organizations function determines tax-exempt organizations were not aware of all filing requirements or how to complete a return.
- Analyzing collection services to assess how Small Business/Self-Employed Division data and resources can best be used to make the non-filer strategy more effective and efficient – The Small Business/Self-Employed Division addresses non-filing by making telephone calls to tax-exempt organizations that have not responded to mail inquiries about potentially delinquent returns. However, over 76 percent (126,585) of the 166,589 tax-exempt organization cases were closed by shelving or suspending further IRS action, which means the returns may still not be filed. The Exempt Organizations function could determine the additional effort required to secure additional returns and the number of returns secured and decide to devote resources to these cases.

Creating a documented, comprehensive non-filer strategy with goals and measures would put the Exempt Organizations function in a better position to: 1) evaluate and improve case selection criteria to ensure that cases with the best potential for affecting the non-filer population are selected; 2) allocate sufficient resources to work non-filer cases; 3) develop indicators specific to



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the non-filer inventory; and 4) measure the effectiveness of the non-filer strategy and make changes as needed.

Recommendations

We recommended that the Director, Exempt Organizations, Tax Exempt and Government Entities Division, develop a documented, comprehensive non-filer strategy with program goals and measures, as well as short-term action plans to implement the strategy. In addition, we recommended that the Director, Exempt Organizations, Tax Exempt and Government Entities Division, determine how best to use Small Business/Self-Employed Division data and evaluate its agreement with the Small Business/Self-Employed Division to ensure that it meets the Exempt Organizations function's needs.

Response

IRS management offered alternative corrective actions for two of our recommendations and agreed with two of our recommendations. The Commissioner, Tax Exempt and Government Entities Division, responded that the Exempt Organizations function would continue working with the agency-wide Non-filer Executive Advisory Council.¹ As part of this effort, agency-wide non-filer strategic measures were approved in August 2008. The Tax Exempt and Government Entities Division is reviewing its non-filer initiatives and identifying how they align with these strategic measures as well as working to develop projects for the future consistent with the overall strategy. The Non-filer Executive Advisory Council plans to meet and discuss the action items for impact to the Fiscal Year 2010 Work Plan and beyond.

The Commissioner, Tax Exempt and Government Entities Division, also indicated that changes implemented by the Pension Protection Act of 2006² will affect currently available data with a corresponding impact on non-filer initiatives. Consequently, management plans to wait until after Tax Year 2009 when it expects the data to more accurately reflect true non-filers. Once the impact of the Pension Protection Act of 2006 is known and more reliable data are available, the Exempt Organizations function plans to incorporate this information into its ongoing development of non-filer projects based upon the agency-wide non-filer strategic measures. In the interim, Exempt Organizations function officials plan to continue educational efforts concerning the filing requirements. Exempt Organizations function officials also plan to evaluate the Memorandum of Understanding for collection services with the Small

¹ The Non-filer Executive Advisory Council is the primary coordination body for the IRS on matters related to non-filing of tax returns across all IRS operating divisions and guides development of agency-wide strategies for improving resource allocation to reduce noncompliance and the tax gap. It is located organizationally under the Deputy Commissioner for Services and Enforcement.

² Pub. L. 109-280, 120 Stat. 780 (2006).



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Business/Self-Employed Division to determine whether it meets the needs of the Exempt Organizations function and whether changes to the Memorandum are needed. Management's complete response to the draft report is included as Appendix IV.

Office of Audit Comment

The Commissioner, Tax Exempt and Government Entities Division, provided alternate corrective actions for our recommendations to develop a documented, comprehensive non-filer strategy with program goals and measures, as well as short-term action plans to implement the strategy. In addition, the Commissioner, Tax Exempt and Government Entities Division, stated that the Exempt Organizations function believes it would be more effective at this time to concentrate on educational activities than to immediately begin work on our recommendation to determine how best to use Small Business/Self-Employed Division data.

While educational activities are important, we believe the Exempt Organizations function should also concentrate on filing compliance by improving current non-filer efforts. For example, although the Exempt Organizations function is working with the IRS to develop a comprehensive non-filer strategy, the Exempt Organizations function did not agree to track and monitor against non-filer goals and measures or make a commitment to conduct analyses on current non-filer cases to determine reasons for non-filing, impact of delinquent return notices, and non-filer trends. Without these improvements, the Exempt Organizations function cannot ensure that current and future efforts are effective in fully addressing noncompliance by tax-exempt organizations.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Nancy A. Nakamura, Assistant Inspector General for Audit (Management Services and Exempt Organizations), at (202) 622-8500.



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Abbreviations

IRS

Internal Revenue Service



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Background

The Exempt Organizations function of the Tax Exempt and Government Entities Division has responsibility for ensuring compliance with the Internal Revenue Code sections and regulations that govern organizations exempt from Federal income tax. Tax-exempt organizations, such as charitable organizations, are generally required to file an annual information return (Return of Organization Exempt From Income Tax (Form 990)) with the Internal Revenue Service (IRS).

Form 990 is used by the IRS, State regulators, the public, and policymakers. The IRS uses Form 990 to assess whether tax-exempt organizations continue to comply with the requirements for tax-exempt status. State regulators also use the information from Forms 990 to address issues concerning governance, charitable purpose, and fundraising regulations. Forms 990 collect much of the information that donors, foundations, the public, and policymakers need to know to make informed business decisions relating to the tax-exempt sector. The Exempt Organizations function released a redesigned Form 990 in December 2007 to enhance transparency, promote compliance, and minimize the burden on tax-exempt organizations. The Exempt Organizations function believes that the revised Form 990 will result in a realistic picture of an organization and its operations and provide a basis for comparing the organization to similar organizations.

The number of organizations that are granted tax-exempt status each year is increasing. According to the Exempt Organizations function, there are approximately 1.8 million tax-exempt organizations in the United States. During Fiscal Year 2007, the IRS reported receiving 901,000 returns from tax-exempt organizations. The remaining tax-exempt organizations are either non-filers that are not required to file annual returns,¹ non-filers that should be filing but are not, or non-filers that are no longer filing because they are no longer in existence.

Prior to beginning our review, we found that tax-exempt organizations may not be filing Forms 990 as required. Information extracted from tax-exempt organizations' tax accounts for Tax Years 2004 through 2006 identified Form 990 filing patterns that may be indicative of filing noncompliance. For example, 3,419 organizations filed Form 990 for Tax Years 2004 and 2006, but not Tax Year 2005.

To address potential non-filers, the Tax Exempt and Government Entities Division works with the Modernization and Information Technology Services organization to develop and execute computer programs that identify tax-exempt organizations that are required to file annual returns, but have not filed in a timely manner. Any tax-exempt organization that has not filed a

¹ Tax-exempt organizations, such as churches and certain religious organizations, certain State and local instrumentalities, and other organizations, are exempted from filing annual returns. In addition, prior to January 2008, tax-exempt organizations reporting annual gross receipts less than \$25,000 were not required to file annual returns.



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Form 990 in a timely manner is sent a notice informing them that their Form 990 was not filed. The Tax Exempt and Government Entities Division has an agreement with the Wage and Investment Division to process replies from these notices, as well as notices returned to the IRS because they could not be delivered. The Tax Exempt and Government Entities Division also has an agreement with the Small Business/Self-Employed Division to handle collection activities, such as calling tax-exempt organizations, when notices go unanswered or the required return is not filed.

The Treasury Inspector General for Tax Administration has conducted two prior reviews of the implementation of initiatives under the IRS-wide Non-filer Strategy. In November 2005, we reported that the IRS did not have: 1) a comprehensive non-filer strategy or an executive charged with overseeing each business division's non-filer efforts; 2) an organization-wide tracking system to monitor the progress of each business division's non-filer strategy action items; and 3) measurable program goals for bringing non-filers into compliance.² We performed a followup review and reported in September 2008 that service-wide outcome and performance measures had not yet been approved, and there was no systemic method in place to track and monitor cases worked as part of service-wide non-filer strategic initiatives.³

This audit was conducted while the Exempt Organizations function was considering how to integrate with the IRS-wide Non-filer Strategy and developing its Fiscal Year 2009 Work Plan. As a result, this report might not reflect the most current status of the IRS' efforts to identify and address tax-exempt non-filers.

This review was performed at the National Headquarters of the Tax Exempt and Government Entities Division in Washington D.C; the Exempt Organizations function Examination office in Dallas, Texas; the Exempt Organizations Compliance Unit in Ogden, Utah; the Exempt Organizations Compliance Strategies and Data Analysis Unit in Washington D.C.; and the Exempt Organizations Submissions Processing Program Office in Ogden, Utah, during the period April through September 2008. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

² *The Internal Revenue Service Needs a Coordinated National Strategy to Better Address an Estimated \$30 Billion Tax Gap Due to Non-filers* (Reference Number 2006-30-006, dated November 2005).

³ *Additional Steps Need to Be Completed to Ensure the Success of the Service-wide Non-filer Strategy* (Reference Number 2008-30-165, dated September 22, 2008).



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Results of Review

The Exempt Organizations function within the Tax Exempt and Government Entities Division has taken many actions in its efforts to identify non-filers and obtain delinquent returns. For example, the Exempt Organizations function created the Compliance Strategies Critical Initiative Office to coordinate strategic planning, monitor progress of critical initiatives, and analyze the results of projects. In addition, examinations and other projects that include efforts to identify non-filers and secure returns are routinely initiated.

Although the Exempt Organizations function is performing activities to secure delinquent returns, we believe steps could be taken to more fully identify and address non-filers. To accomplish this, the Exempt Organizations function needs to develop and document a comprehensive non-filer strategy.

The Exempt Organizations function has taken actions to improve compliance, but has not documented a comprehensive non-filer strategy.

Creating a documented, comprehensive non-filer strategy with goals and measures would put the Exempt Organizations function in a better position to: 1) evaluate and improve case selection criteria to ensure that cases with the best potential for affecting the non-filer population are selected; 2) allocate sufficient resources to work non-filer cases; 3) develop indicators specific to the non-filer inventory; and 4) measure the effectiveness of the non-filer strategy and make changes as needed.

The filing of required tax-exempt organization returns in a timely manner is critical to increasing the ability of taxpayers to accurately view the operations of tax-exempt organizations. When returns are not filed in a timely manner, taxpayers do not have information about the tax-exempt organization to help make their contribution decisions.

The Exempt Organizations Function Has Taken Many Actions to Identify Non-filers and Obtain Delinquent Returns

The Exempt Organizations function has conducted many activities that have helped it identify non-filers and obtain delinquent returns. These activities include:

- **Implementing the Pension Protection Act of 2006⁴** – The Pension Protection Act of 2006 requires tax-exempt organizations, which previously were not required to file an annual return, to file what is known as an e-Postcard.⁵ Tax-exempt organizations that do not file for 3 consecutive years will have their tax-exempt status revoked automatically.

⁴ Pub. L. 109-280, 120 Stat. 780 (2006).

⁵ Annual Electronic Filing Requirement for Small Exempt Organizations (Form 990-N).



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Because small tax-exempt organizations with \$25,000 or less in annual gross receipts were not always required to file before the law was passed, it was difficult for the Exempt Organizations function to determine which tax-exempt organizations were not filing as required versus those that were not required to file. The new requirement for all tax-exempt organizations to file will help the Exempt Organizations function more easily identify true non-filers and thus focus its compliance efforts on more productive cases.

- **Creating a Voluntary Compliance Program** – This Program will allow tax-exempt organizations that come forward voluntarily to file delinquent returns and pay taxes without penalty. The Voluntary Compliance Program is scheduled to be available for use by tax-exempt organizations beginning in Fiscal Year 2009.
- **Conducting examinations** – The Exempt Organizations function conducts examinations of tax-exempt organizations that can include obtaining any delinquent returns. Primarily, Exempt Organizations function audits include determining if the organization is organized and operated in accordance with its exempt purpose, if required forms are correct and complete, and if any other taxes are owed. If during the examination it is determined that a tax-exempt organization has not filed all returns, the Exempt Organizations function examiner will attempt to obtain the delinquent return. During Fiscal Years 2006 and 2007, examinations resulted in 1,506 delinquent returns secured.⁶
- **Compliance checks** – A compliance check is a review conducted to determine whether an organization is adhering to recordkeeping and information reporting requirements. A compliance check is not an examination; it does not directly relate to determining a tax liability for any particular period. During Fiscal Years 2006 and 2007, compliance checks resulted in 782 delinquent returns being secured.⁷
- **Initiating compliance projects** – A compliance project is designed to address an identified issue, such as noncompliance by a particular type of tax-exempt organization. These projects are intended to correct a known area of noncompliance through examinations, compliance checks, educational programs, and other activities that may not involve the examination of books and records. Those that involve examinations typically include returns screened for the presence of a specific issue. For example, the Exempt Organizations function currently is sharing tax data with 18 States to identify tax-exempt organizations that engaged in gaming activities, such as Bingo, in which annual gross receipts normally exceeded \$25,000 and Forms 990 were not filed, as required. Based on this information, the Exempt Organizations function opened examinations on

⁶ Including Form 990, Short Form of Return of Organization Exempt From Income Tax (Form 990-EZ), Return of Private Foundation (Form 990-PF), Exempt Organization Business Income Tax Return (Form 990-T), Employer's Quarterly Federal Tax Return (Form 941), Employer's Annual Federal Unemployment (FUTA) Tax Return (Form 940), and other returns.

⁷ Including Form 990, Form 990-EZ, Form 990-PF, Form 990-T, Form 941, Form 940, and other returns.



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approximately 800 organizations that failed to file Form 990. The Exempt Organizations function plans to issue the results of this effort in Fiscal Year 2009.

While compliance projects normally include a requirement to collect delinquent returns, one compliance project completed in November 2004 was geared specifically toward reviewing non-filers. As part of the project, the Exempt Organizations function determined that almost 88 percent⁸ of tax-exempt organizations that did not file for tax periods ending in late 2001 were actually not required to file or were no longer in existence. For non-filers that should have filed, the Exempt Organizations function conducted additional work to determine the characteristics of non-filers and implemented several recommendations, such as improving the process for mailing letters to tax-exempt organizations that have not filed a required return in a timely manner.

In addition to efforts undertaken by the Exempt Organizations function, the Wage and Investment Division has also taken action to obtain delinquent returns from tax-exempt organizations. The Wage and Investment Division Entity function is responsible for processing replies from tax-exempt organizations to notices informing them that their Form 990 was not filed in a timely manner, as well as notices returned to the IRS because they could not be delivered. We found that proper controls have been established to process and monitor the resolution of these inquiries and responses received from tax-exempt organizations. An Exempt Organizations function official receives a report weekly from the Wage and Investment Division that provides information about the volumes of tax-exempt delinquency notices issued and received by the Wage and Investment Division Entity function. In addition, mechanisms are in place to provide solutions in a timely manner if any problems should occur.

***The Exempt Organizations Function Needs to Develop a
Comprehensive Non-filer Strategy and Design Effective Performance
Measures***

While the Exempt Organizations function has taken actions that have resulted in obtaining some of the delinquent returns, we believe steps could be taken to more fully identify and address non-filers. To accomplish this, the Exempt Organizations function needs to develop and document a comprehensive non-filer strategy.

In August 2006, the Strategic Planning Working Group⁹ recommended creating an overall non-filer strategy for the Exempt Organizations function. An Exempt Organizations function

⁸ According to IRS documentation, the sample used to determine this statistic was based on a sample with a confidence level of 95 percent and a margin of error of +/- 5 percent. Due to the age of the data, we did not attempt to validate the information.

⁹ The Strategic Planning Work Group was established in Fiscal Year 2005 and was charged with soliciting, investigating, and recommending compliance projects for the Exempt Organizations function Work Plan.



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Non-filer Coordinator was appointed in March 2007. However, work on higher priority compliance projects prevented the Coordinator from focusing on a non-filer strategy.

In May 2008, the Exempt Organizations function's Program Manager, Compliance Strategies Critical Initiatives, indicated that a proposal for a non-filer strategy was scheduled to be submitted to the Exempt Organizations function's Executive Steering Committee¹⁰ in October 2008 and would include project goals and performance measures. However, a non-filer strategy was not published in October 2008. The Director, Exempt Organizations, believed it was premature to create a documented strategy because the IRS-wide non-filer strategic measures were early in development and it was important that an Exempt Organizations function non-filer strategy align with the overall IRS-wide strategic measures. In addition, the Director, Exempt Organizations, stated that the previously mentioned actions being undertaken constituted the Exempt Organizations function's current plan for identifying and addressing non-filers. Also, pending the completion of the agency-wide non-filer strategic measures, the Director did not want to stifle the creativity of the function in developing new and innovative methods to pursue non-filers. Lastly, the Exempt Organizations function's Compliance Strategies Critical Initiatives Program Manager stated that the function was developing a compliance project that will focus on specific characteristics of non-filers.

Notwithstanding these reasons for delay, we believe a strategy is needed to guide and improve current and future efforts to identify and address non-filers. Specific details could be put into short-term action plans that would provide a detailed description of specific actions needed to implement the non-filer strategy, target implementation dates, and responsible officials.

Without a documented, comprehensive strategy, the Exempt Organizations function cannot ensure that current and future efforts are effective in fully addressing noncompliance by tax-exempt organizations. Such a strategy would assist the Exempt Organizations function in focusing, monitoring, and measuring its non-filing efforts. The strategy could address several areas where we believe current and future efforts should be improved to more fully identify and address non-filers, such as:

- Creating overall program goals and performance measures related to all non-filer efforts, including the Voluntary Compliance Program, examinations, compliance projects, the process of sending notices to tax-exempt organizations that have not filed in a timely manner, and the process of calling taxpayers that have not responded to notices.
- Establishing plans for conducting analyses of non-filer project results.
- Analyzing collection services to assess how Small Business/Self-Employed Division data and resources can best be used to make the non-filer strategy more effective and efficient.

¹⁰ The Exempt Organizations function's Executive Steering Committee is responsible for reviewing and approving Strategic Planning Working Group Work Plan recommendations.



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The Exempt Organizations function needs overall program goals and performance measures for bringing non-filers into compliance. While the Exempt Organizations function determined that tax-exempt organizations were largely compliant for tax years ending in late 2001, it is difficult to determine the success of current efforts to address non-filing because the Exempt Organizations function has not yet developed overall goals, as well as performance measures related to non-filers. For example, data on the number of notices generated are captured but the Exempt Organizations function has not recently measured how this relates to the number of delinquent returns secured. Without measures, it will be difficult to determine progress in addressing non-filers.

The Government Performance and Results Act of 1993¹¹ requires that plans have general goals and objectives, including outcome-related goals and objectives. It also requires a description of how the goals and objectives will be achieved, skills and technology required, human capital¹² information, and other resources required.

Management Action: Exempt Organizations function officials informed us that they were planning to develop measures in support of the IRS-wide Non-filer Strategy.

The Exempt Organizations function should conduct analyses of project results. According to Returns Inventory and Classification System¹³ data provided by the Exempt Organizations function, the Exempt Organizations function conducted 65 compliance projects that resulted in 1,255 delinquent Form 990¹⁴ returns secured and 502 delinquent Form 990-related returns secured during the period October 1, 2005, through March 31, 2008. However, Exempt Organizations function officials had not analyzed project results for any non-filer related trends similar to the analysis completed as part of the compliance project it conducted on Tax Year 2001 data. For example, compliance personnel did not conduct an analysis to determine if project results identified any consistent reasons for non-filing. Case results were also not analyzed to determine why non-filers remained noncompliant despite IRS efforts to contact the organization through mail or telephone contacts to bring the organization into compliance. In addition, project data were not always collected in a consistent manner to allow trending, and Exempt Organizations function officials indicated that no one in the Exempt Organizations function had requested a trend analysis of non-filer information.

Exempt Organizations function officials could analyze the results of compliance projects and examinations that have resulted in securing delinquent returns to identify problem areas and trends. Identifying such trends could help the Exempt Organizations function focus its resources

¹¹ Pub. L. No. 103-62, 107 Stat. 285 (codified as amended in scattered sections of 5 U.S.C., 31 U.S.C., and 39 U.S.C.).

¹² The term “human capital” is used to describe the skills, abilities, and contributions of the people in an agency.

¹³ The Returns Inventory and Classification System provides users access to return and filer information related to the filing and processing of employee plans, exempt organizations, and government entities forms.

¹⁴ Statistics include Form 990, Form 990-EZ, and Form 990-PF.



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on non-filer problems more effectively. In addition, trend analyses could be used to develop education materials and thus help to reduce noncompliance among tax-exempt organizations if the Exempt Organizations function determines tax-exempt organizations were not aware of all filing requirements or how to complete a return.

The Exempt Organizations function should evaluate the effectiveness of collection services provided by the Small Business/Self-Employed Division. In addition to Tax Exempt and Government Entities and Wage and Investment Divisions efforts to address tax-exempt organizations that do not file, the Small Business/Self-Employed Division also addresses non-filing by making telephone calls to tax-exempt organizations that have not responded to mail inquiries about potentially delinquent returns. A Memorandum of Understanding between the Tax Exempt and Government Entities and Small Business/Self-Employed Divisions sets forth the delivery of these services, including the delivery of reports that show the number of Tax Exempt and Government Entities Division delinquent tax returns, number of delinquent returns secured, and number of cases moved into a holding area for possible future processing.

We identified some useful data in these reports related to non-filing, yet personnel in the Exempt Organizations function were unaware of these reports. Although Exempt Organizations function officials did not believe the reports would be useful when we brought them to their attention, they contacted Small Business/Self-Employed Division officials to explore the feasibility of acquiring other reports that would be more useful for identifying tax-exempt non-filers. In addition, Exempt Organizations function officials could not identify who in the Exempt Organizations function was responsible for determining whether changes to the Memorandum of Understanding were needed and negotiating those changes with the Small Business/Self-Employed Division.

One of the reports¹⁵ showed that for Fiscal Year 2008, there were 166,589 closed cases involving tax-exempt organizations that did not file returns. Of these, over 76 percent (126,585) of the cases were closed by shelving or suspending further IRS action, which means the returns may still not be filed. A Small Business/Self-Employed Division official stated that it was possible these cases may come back into worked inventory, but the official added that cases involving tax-exempt organizations are given low priority because many of the cases have little or no taxes due. This report also showed that 11,737 (7 percent) of the cases were closed as unable to locate, while only 4,159 (2.5 percent) returns were secured during Fiscal Year 2008. Figure 1 shows by category, the number and percentage of tax-exempt cases closed by the Small Business/Self-Employed Division in Fiscal Year 2008.

¹⁵ Exempt Organizations Report of Delinquent Return Notices and Investigations.



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**Figure 1: Fiscal Year 2008 Tax-Exempt Case Closures in the
Small Business/Self-Employed Division**

Reason for Closing Case	Number of Cases Closed	Percentage of Cases Closed¹⁶
Shelved or Suspended	126,585	76.0 percent
Tax-Exempt Organization Not Liable to File	13,571	8.1 percent
Unable to Locate Tax-Exempt Organization	11,737	7.0 percent
Return Filed by Tax-Exempt Organization	8,696	5.2 percent
Return Secured by IRS Agent	4,159	2.5 percent
Other Closings	1,841	1.1 percent

Source: Exempt Organizations Report of Delinquent Return Notices and Investigations. We did not verify this information because we did not have a basis for comparison.

The Small Business/Self Employed Division is responsible for the collection of delinquent returns and taxes owed by all taxpayers, not just those owed by tax-exempt organizations. As a result, it has to prioritize the collection work among the various taxpayer groups and because tax-exempt organizations tend to owe less in taxes, tax-exempt organization returns are not a very high priority. While we understand that difficult decisions have to be made on the priority of IRS case work, we believe that the Exempt Organizations function needs to determine whether adequate attention is being provided to cases closed as shelved, suspended, or unable to locate. By determining the additional effort required to secure additional returns and the number of returns secured similar to the effort it made concerning Tax Year 2001 tax-exempt organizations, the Exempt Organizations function could decide to devote resources to these cases or renegotiate the Memorandum of Understanding with the Small Business/Self-Employed Division.

¹⁶ Numbers will not add up to 100 percent due to rounding.



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Recommendations

The Director, Exempt Organizations, Tax Exempt and Government Entities Division, should:

Recommendation 1: Develop and document a comprehensive non-filer strategy as a critical initiative in the Fiscal Year 2010 Exempt Organizations function Work Plan. The strategy should, at a minimum, include:

- Program goals.
- Program measures, such as voluntary filing compliance rate, non-filer repeater rate, and percent of non-filer returns secured each year.
- High-level actions planned to track and monitor the results of non-filer work.
- High-level plans for conducting analyses to determine reasons for non-filing, impact of delinquent return notices, and non-filer trends.
- Linkage to the IRS-wide Non-filer Strategy.

Management's Response: The Commissioner, Tax Exempt and Government Entities Division, provided alternate corrective actions for this recommendation. The Exempt Organizations function plans to continue to work with the agency-wide Non-filer Executive Advisory Council, which was created to develop a comprehensive non-filer strategy for the IRS. As part of this effort, agency-wide non-filer strategic measures were approved in August 2008, and the Council identified how Fiscal Year 2009 non-filer actions, including those of the Exempt Organizations function, align with the IRS Commissioner's Strategic Goals, with non-filer initiatives, and with the recently approved agency-wide non-filer strategic measures. The Non-filer Executive Advisory Council plans to meet and discuss the action items for impact to the Fiscal Year 2010 Work Plan and beyond.

Recommendation 2: Develop short-term action plans that include target implementation dates and responsible officials for actions needed to implement the non-filer strategy.

Management's Response: The Commissioner, Tax Exempt and Government Entities Division, provided alternate corrective actions for this recommendation. The Commissioner, Tax Exempt and Government Entities Division, responded that the Fiscal Year 2009 Work Plan contains a Form 990 Non-filer Initiative focused on organizations with reported high dollar gross receipts that file Form 990 or Form 990-PF intermittently and another initiative for organizations that did not file Form 990, but did file either a Form 990-T with substantial gross receipts from unrelated business income or a Contributions of Motor Vehicles, Boats, and Airplanes (Form 1098-C) reporting high donations. The Work Plan includes target implementation dates and identifies responsible officials.



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Office of Audit Comment: The Commissioner, Tax Exempt and Government Entities Division, provided alternate corrective actions for our recommendations to develop a documented, comprehensive non-filer strategy with program goals and measures, as well as short-term action plans to implement the strategy. Although the Exempt Organizations function is working with the IRS to develop a comprehensive non-filer strategy, the Exempt Organizations function did not agree to track and monitor against non-filer goals and measures or make a commitment to conduct analyses on current non-filer cases to determine reasons for non-filing, impact of delinquent return notices, and non-filer trends. Without these improvements, the Exempt Organizations function cannot ensure that current and future efforts are effective in fully addressing noncompliance by tax-exempt organizations.

Recommendation 3: Determine how Small Business/Self-Employed Division data can best be used to make the Exempt Organizations function non-filer strategy more effective and efficient. For example, a sample of cases that have been shelved or suspended could be worked by the Exempt Organizations function to determine if additional effort is warranted to obtain delinquent returns.

Management's Response: IRS management agreed with the recommendation and will evaluate the status of non-filers, making use of Small Business/Self-Employed Division and other data demonstrating the impact of the Pension Protection Act of 2006, when the data become available. The Exempt Organizations function indicated that the Small Business/Self-Employed Division data include organizations that are not true non-filers, either because they have low receipts or have gone out of business. Under the Pension Protection Act of 2006, tax-exempt organizations (other than certain excepted entities such as churches) that do not file a Form 990, Form 990-EZ, or Form 990-N for 3 consecutive years will automatically lose their tax-exempt status in 2010. Therefore, the Exempt Organizations function believes it should continue its educational efforts concerning the filing requirements and evaluate the status of non-filers when the impact of the Pension Protection Act of 2006 is clear.

Office of Audit Comment: The Commissioner, Tax Exempt and Government Entities Division, replied that the Exempt Organizations function believes it would be more effective at this time to concentrate on educational activities than to immediately begin work on our recommendation. While educational activities are important, we believe the Exempt Organizations function should also concentrate on filing compliance by improving current non-filer efforts. For example, Exempt Organizations function officials stated that reports being received from the Small Business/Self-Employed Division were not useful and they were exploring the feasibility of acquiring other reports that were more useful. Work in this area could be completed now so that reports will be useful by the time the Pension Protection Act of 2006 begins impacting data. In addition, work could be started now to determine whether additional effort is warranted to obtain



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delinquent returns from a large pool of potential tax-exempt non-filer cases that are currently not being worked. While waiting for data to be impacted by the Pension Protection Act of 2006, the Exempt Organizations function could influence future non-filer efforts and learn how to reduce current noncompliance by determining reasons for non-filing, impact of delinquent return notices, and non-filer trends as it secures delinquent returns.

Recommendation 4: Evaluate the Memorandum of Understanding for collection services with the Small Business/Self-Employed Division to ensure that it meets the needs of the Exempt Organizations function and periodically consider whether changes to the Memorandum are needed.

Management's Response: IRS management agreed with the recommendation. Exempt Organizations function officials plan to evaluate the Memorandum of Understanding for collection services with the Small Business/Self-Employed Division to determine whether it meets the needs of the Exempt Organizations function and whether changes to the Memorandum are needed.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to assess the Tax Exempt and Government Entities Division's efforts to effectively address Return of Organization Exempt From Income Tax (Form 990) filing compliance. To accomplish our objective, we:

- I. Assessed actions taken by the Exempt Organizations function to develop a non-filer strategy.
 - A. Interviewed Exempt Organizations function officials to determine the status of efforts to develop a non-filer strategy and identify a national Non-filer Coordinator.
 - B. Assessed the progress made by the Exempt Organizations function in developing a non-filer strategy.
 - C. Determined how the planned Voluntary Compliance Program for tax-exempt organizations may fit into a non-filer strategy.
 - D. Determined how the implementation of the e-Postcard will fit into the non-filer strategy.
- II. Assessed actions taken to systemically identify potential non-filers.
 - A. Assessed the notice process for weaknesses.
 - B. Interviewed Exempt Organizations function and Modernization and Information Technology Services organization personnel responsible for the notice process to clarify our understanding of the process and the impact of any proposed changes.
- III. Evaluated Tax Exempt and Government Entities Division oversight activities of other IRS organizations responsible for addressing Form 990 compliance.
 - A. Assessed how the Tax Exempt and Government Entities Division provides oversight to Wage and Investment Division efforts to process tax-exempt organization notices and responses.
 - B. Assessed how the Tax Exempt and Government Entities Division provides oversight to Small Business/Self-Employed Division efforts related to tax-exempt organizations.



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- IV. Assessed Exempt Organizations function efforts to address non-filer issues using compliance projects.
- A. Determined whether the Exempt Organizations function had performed an analysis of the results of the non-filer components of all compliance projects for trends.
 - B. Determined the status of Exempt Organizations function plans to initiate a non-filer compliance project.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: Exempt Organizations function's policies, procedures, and practices for identifying and addressing Form 990 non-filers. We reviewed these controls by interviewing management and analyzing applicable information and documents.



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Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Commissioner, Small Business/Self-Employed Division SE:S
Commissioner, Wage and Investment Division SE:W
Deputy Commissioner, Tax Exempt and Government Entities Division SE:T
Director, Exempt Organizations, Tax Exempt and Government Entities Division SE:T:EO
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
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Audit Liaisons:
 Director, Communications and Liaison, Small Business/Self-Employed Division
 SE:S:CLD:PSP:GTL
 Director, Communications and Liaison, Tax Exempt and Government Entities Division
 SE:T:CL
 Senior Operations Advisor, Wage and Investment Division SE:W:S



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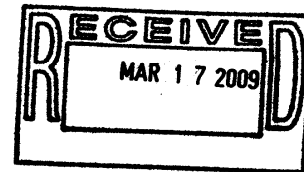
Appendix IV

Management's Response to the Draft Report



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

MAR 16 2009



MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Commissioner, Tax Exempt and Government Entities
Division *Joseph H. Grant for*

SUBJECT: Response to Draft Audit Report – A Documented
Comprehensive Strategy Is Needed to Focus Efforts on Ensuring
Compliance by Tax-Exempt Non-Filers (Audit # 200810021)

This responds to your draft audit report concerning the Exempt Organizations function's efforts to address Form 990 filing compliance.

Your report notes that the EO function has taken many actions to identify non-filers and obtain delinquent returns. The report also suggests that a comprehensive, documented strategy with goals and measures would put EO in a better position to address Form 990 filing compliance.

EO is working with the rest of the IRS to develop a comprehensive non-filer strategy for the entire IRS. As part of this effort, servicewide non-filer strategic measures were approved last August. All of the operating divisions are now reviewing their non-filer initiatives and identifying how they align with these strategic measures as well as working to develop projects for the future consistent with the overall strategy.

Your report also suggests that we use SB/SE data to make our non-filer strategy more effective and efficient. However, changes implemented by the Pension Protection Act of 2006 (PPA) will affect the currently available data with a corresponding impact on non-filer initiatives. Previously, we were unable to tell whether a non-filing organization had low enough gross receipts that it was not required to file, no longer existed, or simply chose not to file. Under PPA, exempt organizations that previously did not have a filing requirement for all or some of their years due to low gross receipts, now have an annual filing requirement regardless of receipt levels beginning with their 2007 tax year. PPA also provides that those that fail to file Form 990, Form 990-EZ, Form 990-PF or Form 990-N for three consecutive years will automatically lose their tax-exempt status. As a result, we expect our data following the 2009 tax year to more accurately reflect true non-filers. EO believes that, rather than use the data from its current non-filer projects, it is effective at this time to educate organizations about the change in the law, the potential loss of exemption for failure to file, and the recent revisions to the



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Form 990. Once the impact of PPA is known and more reliable data is available, EO will incorporate that into its ongoing development of non-filer projects based upon the servicewide non-filer strategic measures.

Our response to your recommendations appears on the attachment.

Attachment



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Recommendation 1

Attachment

Develop and document a comprehensive non-filer strategy as a critical initiative in the Fiscal Year 2010 Exempt Organizations function work plan. The strategy should, at a minimum, include:

- Program goals.
- Program measures, such as, voluntary filing compliance rate, non-filer repeater rate, and percent of non-file returns secured each year.
- High-level actions planned to track and monitor the results of non-filer work.
- High-level plans for conducting analyses to determine reasons for non-filing, impact of delinquent return notices, and non-filer trends.
- Linkage to the IRS-wide Non-filer Strategy.

Comment

While EO does not plan to include a comprehensive non-filer critical initiative in its FY 2010 Work Plan, EO will continue to work with the servicewide Non-Filer Executive Advisory Council (NF EAC). The NF EAC was created to develop a comprehensive non-filer strategy for the IRS. The NF EAC includes representatives from all of the business operating divisions and functions within the IRS that are impacted by non-filers, including TE/GE. The NF EAC developed servicewide non-filer strategic measures that were approved in August 2008, and identified how FY 2009 non-filer actions, including those of EO, align with the Commissioner's Strategic Goals, with non-filer initiatives and with the recently approved servicewide non-filer strategic measures. The NF EAC plans to meet and discuss the action items for impact to the FY 2010 Work Plan and beyond.

Corrective Action

EO will continue to work with the servicewide NF EAC, and will develop and document non-filer initiative projects consistent with the NF EAC strategy.

Implementation Date

September 20, 2010

Responsible Official

Rob Choi, Director, EO Rulings & Agreements
Sunita Lough, Director, EO Examinations



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Recommendation 2

Develop short-term action plans that include target implementation dates and responsible officials for actions needed to implement the non-filer strategy.

Corrective Action

The FY 2009 Work Plan contains a Form 990 Non-Filer Initiative focused on organizations with reported high dollar gross receipts that file Form 990 or Form 990-PF intermittently and on organizations that did not file Form 990 but did file either a Form 990-T with substantial gross receipts from unrelated business income or a Form 1098-C reporting high donations. The work plan includes target implementation dates and identifies responsible officials.

Implementation Date

Completed

Responsible Official

Lois G. Lerner, Director, EO



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Recommendation 3

Determine how SB/SE data can best be used to make the EO function non-filer strategy more effective and efficient. For example, a sample of cases that have been shelved or suspended could be worked by the EO function to determine if additional effort is warranted to obtain delinquent returns.

Comment

The referenced SB/SE data includes organizations that are not true non-filers, either because the organization has low receipts or has gone out of business. Under PPA, exempt organizations (other than certain excepted entities such as churches) that do not file a Form 990, Form 990-EZ, Form 990-PF or Form 990-N for three consecutive years will automatically lose their tax-exempt status in 2010. Therefore, EO believes it should continue its educational efforts concerning the filing requirements and evaluate the status of non-filers when the impact of the PPA provisions is clear.

Corrective Action

EO will evaluate the status of non-filers, making use of SB/SE data and other data demonstrating the impact of PPA, when that data becomes available.

Implementation Date

April 30, 2011

Responsible Official

Sunita Lough, Director, EO Examinations



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Recommendation 4

Evaluate the Memorandum of Understanding for collection services with the Small Business/Self Employed Division to ensure that it meets the needs of the Exempt Organizations function and periodically consider whether changes to the Memorandum are needed.

Corrective Action

EO will evaluate the Memorandum of Understanding for collection services with SB/SE to determine whether it meets the needs of EO, and will consider whether changes to the Memorandum are needed.

Implementation Date

December 31, 2009

Responsible Official

Rob Choi, Director, EO Rulings & Agreements
Sunita Lough, Director, EO Examinations