

Remarks at the Greater Washington Society of CPAs
by Mark W. Everson, Commissioner of Internal Revenue
in Washington, D.C.
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Introduction

Thank you Stanley, thank you Daniel and thank you all, ladies and gentlemen.

As you well know, tax administration is not just the job of the IRS. Your profession is a vital component of our tax system. More than a million tax professionals help Americans pay taxes promptly and accurately. I want to thank the Greater Washington Society of CPAs, in particular for your valuable input to the project to re-write Form 990.

I appreciate this opportunity to discuss charities and tax-exempt organizations. Our country rightfully takes pride in its tax-exempt sector. It is composed of millions of dedicated volunteers and staff who faithfully and impressively carry out critically important work. Upon them, many within the United States and throughout the world rely.

My remarks will focus on problems with abuse in the tax-exempt area. In making these observations, I am not talking about the inspiring work that the charitable community does day-in and day-out. Nor am I

overlooking that the overwhelming majority of organizations try and do in fact comply with the letter and spirit of the law.

Before I discuss your sector in detail, let me share with you some general observations concerning tax administration.

When I was before the Senate Finance Committee in March 2003 for my confirmation hearing, I articulated three goals for the IRS: better service to taxpayers; significant enhancement of our enforcement activities to ensure that everyone pays their fair share; and continued modernization of IRS systems and business processes.

Just over halfway into my five year term, I am pleased to report progress in each area. We have restored credibility to our enforcement programs and brought in billions more to the Treasury, but not at the expense of service to taxpayers. And we have taken important steps to modernize -- most notably, electronic filing.

Let me turn to some of the highlights for the fiscal year ended September 30th:

Enforcement revenues – the monies we get from our collection, examination, and document matching activities – increased by 10% to a record \$47.3 billion. Total individual returns audited increased by 20% to over 1.2 million. Audits of individuals with incomes over \$100,000 reached the highest figure in 10 years.

Audits of small businesses organized as corporations turned up after years of decline. Audits of larger corporations – those with assets over \$10 million – increased 14% from a year ago. And our levies, liens and seizures have all been increasing

As I said a moment ago, these gains did not come about at the expense of taxpayer service. Our toll-free tax law accuracy hit a high of 89%. Our telephone level of service – the measure of how many people get through when they call -- was 83%, well above the 62% of just 4 years ago. And customer satisfaction with our toll-free service was 94%.

We have also made strides in computer modernization. This year, for the first time, over half of all individual returns were filed electronically. And for the first time in 40 years, the IRS is processing tax returns on a new computer system

Enforcement Challenges Are Increasing in the Tax Exempt Area

Turning to today's subject, we are strengthening enforcement in the tax exempt sector. The IRS Strategic Plan sets out four key objectives designed to enhance tax law enforcement from the years 2005 to 2009. One of these objectives directly addresses the sector. It is to deter abuse within tax-exempt and governmental entities and misuse of such entities by third parties for tax avoidance and other unintended purposes.

The stakes here are significant. If individuals and organizations which should be taxed masquerade as charities, over time there will be an erosion of our nation's revenue base. And perhaps more importantly, if abuses cause us to lose faith in our charities, Americans will stop giving and those in need will suffer.

I believe there are several factors that account for the emergence of problems in the tax-exempt area. First, there was a dramatic increase in the size and complexity of the sector and the organizations within it. Second, during this time period, IRS enforcement resources did not keep up -- in fact, they declined, making it more difficult to administer the law. Third, some of the problems that we saw in profit-making businesses -- such as lax attitudes toward governance -- have appeared in the non-profit arena as well. Finally, there has been a rise in abusive tax avoidance

transactions generally, including a number that involve tax exempts. As I testified to Congress earlier this year, the twin cancers of technical manipulation and outright abuse that we saw develop some years ago in the profit-making sector of the economy are now spreading to parts of the non-profit sector.

The IRS is acting. Let me give you four examples of our renewed enforcement efforts. These examples involve situations in which a charity itself is abusing its status or where others are using the charity for unintended purposes: credit counseling, executive compensation, abusive tax schemes and prohibited political intervention.

Credit Counseling Organizations

My first example is credit counseling. Tax exempt credit counseling organizations traditionally have helped Americans reduce their borrowing costs and do a better job of financial planning in difficult situations. Unfortunately, in recent years, too many organizations got into this field not to help others but as a business to enrich insiders or related for-profit associates.

I get phone calls from these organizations at home. They're exempt from the do-not-call list because they're charities. They're saying, well, Mr. Everson, how come we haven't heard from you to help get rid of your credit card debt? Well, we pay our credit card bills each month.

Occasionally calls like these result in an inquiry back at the IRS – an inquiry referred by concerned persons such as myself. By the end of the year, I expect that we will have proposed the revocation of the tax-exempt status of 20 to 25 so-called credit counseling organizations, representing as much as half the gross receipts of this industry. That's how bad this is. And it's all the more important because the new bankruptcy law will channel families – before they file – into credit counseling.

Excessive Compensation of Some Tax Exempt Executives

A second challenge we face is the excessive compensation of some executives of tax exempt organizations. I use this as an example of something we have seen across much of the tax exempt sector. Of course, an exempt organization is entitled to pay reasonable compensation based on the value of the services it receives. However, there are indications that organizations have allowed key executives too great a voice in determining their own compensation or have otherwise not done due diligence in setting compensation levels.

To address this problem we have contacted a broad spectrum of nearly 2000 501(c)(3) organizations, including 400 private foundations. These contacts have uncovered a variety of troubling practices. In one glaring example, executives salaries consumed nearly half of the organization's gross revenues. In other instances, we have found executives who hire their wife and children and pay them generously while asking them for little or no work. We have found organizations that pay the executives' personal expenses – their automobiles and family travel – and organizations that pay large salaries that cannot be supported by comparable salaries paid to similar executives. We have also found issues relating to proper reporting and to questionable loan transactions.

While we continue to conduct traditional field examinations, in other instances we are sending organizations letters limited to asking for detailed information and supporting documents on their compensation practices and procedures, specifically how they set and report compensation for individual executives. We also are asking organizations for details concerning the independence of the governing body that approved the compensation.

In particular, over the months ahead, I expect in 2006 we will scrutinize executive loans and take a closer look at compensation of hospital executives.

Abusive Transaction Settlement Initiative/ Patents and Conservation Easements

Let me to turn to a third area of focus. You may know about the abusive transactions settlement initiative we announced in October. Several of the transactions in this initiative involve charities – in some cases acting as recipients of questionable donations, and in others acting as facilitators of abusive transactions. One of the abuses we are aiming at is excessive deductions for the donation of patents or conservation easements to tax-exempt entities.

Let me be very clear. There are many good donations of patents and conservation easements – many cases where the contributions are appropriately valued and the deductions are fully justified. We are not being bull-headed about this. But nor are we naïve. We have seen too many cases where the taxpayer's behavior cannot pass the smell test. Our

settlement initiative affords taxpayers who have inflated their deductions to turn the page. Its terms are fair.

We are concerned about exempt organizations being used unwittingly, or what is worse, permitting themselves to be used, as a facilitator or an accommodation party for an abusive transaction. Whether we learn of an exempt organization's involvement in such a scheme through the settlement initiative, or from our other sources, exempt organizations involved in these transactions can expect to hear from us.

Tax Exempts and Political Activity

Finally, I would like to touch on our work on prohibited political activity.

The amount of money sloshing about in the political process threatens to become a surge that will breach our statutory levies and overwhelm our democracy. FEC regulated organizations spent \$4 billion in the 2000 elections and more than twice that in the last cycle. Last year, we saw a large increase in complaints about political intervention by 501(c)(3)'s.

We conducted more outreach – for example, educating the public and explaining the law to the major political parties. But we also communicated directly, on a timely basis, with those whom we had reason to believe may have intervened inappropriately in the political process. We have contacted more than 130 organizations; almost half of these were churches. We are nearing completion of our initial inquiries; most of the problems we found seem to be one-time events easily resolved.

We intend to stem the use of charities for improper purposes and enforce the prohibition against political intervention set down in the Code. Free speech and religious liberty are fundamental, well established rights in our society. But Congress has said that an organization that wants to enjoy the significant benefits of tax exemption must not support or oppose political candidates. We will be finalizing our work on the '04 election cycle in the coming months. The '06 election cycle will fast be upon us.

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As we combat abusive activity, we are getting more budget resources. Although the overall IRS budget increased only one-half of one percent in fiscal year 2005, the exempt organization examinations budget increased 23 percent.

Last month, Congress approved a four percent increase for the 2006 IRS budget, including a nearly eight percent increase in enforcement. We are using some of this funding to do more in the tax exempt area.

We are not alone in our efforts to preserve the integrity of tax exempts. The Finance Committee, the Ways and Means Committee and the Joint Committee on Taxation are all actively pursuing the subject. I applaud the leadership of Congress on this issue.

Moreover, the tax exempt community itself is addressing the issues at hand. A recent report on problem area -- and potential remedies -- was issued by the Panel on the Nonprofit Sector, convened by Independent Sector and supported by the Council on Foundations. The report is an important contribution. We commend those in the sector for their responsible leadership. I only wish that the accounting, legal and business communities had been similarly responsible about confronting abuses and the erosion of professional ethics when they first had the chance to do so -- as corporate governance problems and the proliferation of shoddy tax shelter promotions began to appear.

Three Points to Consider

Before closing, I would like to reiterate three points that I made before the Senate Finance Committee earlier this year concerning potential legislative action.

First, intermediate sanctions. We need to ask whether the IRS has the flexibility it needs to respond to compliance problems. We are too frequently forced to choose between inconsequential penalties on the one hand or the too severe an option -- revocation of tax exempt status -- on the other. De minimis penalties may have little impact on the troublesome behavior, but revocation may not be in the public interest.

Second, transparency. Transparency is a lynchpin of compliance within the tax-exempt sector. We need the to increase mandatory electronic filing for organizations with filing obligations.

Third, sharing information with other federal and state regulatory agencies. Just as we share information with state tax administrators, we should be able to coordinate with those who regulate charities.

Conclusion

Thank you for inviting me here this morning, and thank you for all the good work that you and your tax exempt clients do. I'd be glad to take your questions and comments.
