

**Prepared Remarks of Lois Lerner**  
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**Georgetown University Law School**  
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Thank you for that kind introduction. It is always a pleasure to appear at the Georgetown conference. I have been coming to this conference as an IRS speaker for about 10 years. I believe Celia Roady has been active in setting the program for most, if not all that time. So, I would be remiss if I didn't thank Celia for her continued efforts to make this conference a success. It's hard work. I know there are lots of other folks, including many of my staff, who work with Celia on the program, so let's take a minute to give all of them a hand.

In thinking about this speech, I reached out to members of the TEGE Advisory Committee (the ACT), who represent different parts of the sector, and asked them what they thought the audience would like to hear about from the IRS. There were lots of suggestions, but the one that intrigued me most was, and I quote, "why don't you lift the veil on the Exempt Organizations office." Let us have a glimpse of what goes on in your office. Tell us about what you and your staff think about when we aren't around, and how it might effect us.

So this year, I'm going to do just that—I'm going to share some of the things that we're mulling over during planning discussions.

The first is governance. That's a topic that's been around for a while, but one that is important to us. What's new, though, is that I have something to report on the research we have been conducting on the intersection between good governance and tax compliance. We've analyzed the governance check sheets we've been preparing at the end of exams over the past several years.

We also will talk about a project we are launching on significant diversions of assets. It happens! People get their hands on exempt organization assets and divert them from their intended charitable purpose. I'll let you in on our thinking about how to approach this concern.

We'll look at some of the unexpected things organizations have been doing with the Form 990-N. Some organizations have filed both a 990-N and a 990 in the same year. Some large organizations filed e-postcards even though it appears they weren't entitled to. What's going on?

I know you are always interested in how promptly we review the determination applications you send in and why delays might occur.

But before I get into the details on those topics, I need to sound the alarm and WARN you about an important issue of the day.

When you are preparing any version of a Form 990, please make sure that you do not include Social Security numbers anywhere on it. Don't include Social Security numbers on the form itself, on any schedule, or on any attachment that you append to the return. The IRS doesn't ask for Social Security numbers on a 990, and we don't want them. AND if someone does put Social Security numbers on the form, we don't have the discretion to redact them. The IRS is required to make the 990s you file publically available. The only information we have authority to redact is Schedule B contributor information. (That exception does not apply to 990-PFs).

The issue here, of course, is potential identity theft. It has been all over the news. A recent Chronicle of Philanthropy article reported that nearly **one in five** exempt organizations – 20 % – have submitted forms with one or more Social Security numbers in them. The Chronicle was reporting on a study that examined more than three million Form 990s that were filed from 2001 to 2006. Over 132,000 charities included at least one Social Security number on their tax forms.

According to the Chronicle's report, most of the Social Security numbers were those of donors, trustees, employees, directors, and scholarship winners. Slightly more than a third of the SSNs were those of the tax preparers themselves. The tax preparers wrote their social security number instead of their PTIN on the form they prepared.

Another way SSNs from EO returns get into the public domain is when an organization takes a document that is prepared for some non-tax purpose, and that contains social security numbers – a list of scholarship winners, for example – and attaches it to the Form 990.

These aren't errors that only small organizations make. The Chronicle reviewed the 990s of the 12 organizations at the top of its Philanthropy 400 ranking of charities. These are the organizations that raise the most from private sources. Of the 12, three organizations – 25% – had published the Social Security number of at least one individual.

As I noted, the study looked at 990s filed from 2001-2006. Since the 990 was redesigned in 2008, our instructions have warned preparers against entering a Social Security number next to their names, and the instructions make clear that a social

security number – once entered – cannot be redacted. Our website contains a similar warning about protecting personal information.

I don't need to tell you that identity theft is a serious and growing problem. The IRS is dedicated to protecting personal information. Because the law doesn't allow the IRS to redact social security numbers when we make 990s public, it's important for organizations, preparers, and you, to make sure this kind of information isn't put on the form, which creates a risk of identity theft. OK—I've delivered the warning, let's move on to those topics I mentioned earlier.

## *Governance Background*

First, let's talk about a topic that the IRS has regularly discussed at this conference: Governance and its relationship with tax compliance. Ever since we first started talking about governance, we have been saying that we believe there is a direct relationship between exempt organizations adopting and following good governance practices and their compliance with the tax code. Today, I'm going to take this concept one step further, and share some research results about that relationship.

But first, I know that there are always plenty of new people at this conference, so I'd like to give you a short summary of IRS interest in this area.

Several years ago, we started a dialogue about the role good governance has in fostering compliance with the Code. We began that dialogue by saying that we believe a well-governed organization is more likely to be compliant with the tax law. And over the past few years, we have been active in the governance area in a variety of ways, including putting educational pieces on our Web site that encourage leaders of nonprofits, of all sizes and types, to consider key governance issues throughout the entire life cycle of their organizations, from cradle to grave.

The crown jewel of our governance efforts is Part VI of the revised Form 990. Part VI asks about the composition and independence of the governing body, about governance policies and procedures, and about whether, and how, an organization makes governance and financial information available to the public.

But it wasn't always that way. When the IRS first started talking about governance, some agreed with our posture, but others responded with reluctance and skepticism. They argued that the Code doesn't speak to governance, so there was no legal authority for the IRS to involve itself in this area. In short, we got a fair amount of pushback.

In response, we asked the ACT to take a look at this issue. They produced an interesting and comprehensive report on the area. One of their recommendations was

that we ensure that all of our employees have a clear and uniform understanding of what they are to do with governance issues when they encounter them.

From the beginning we've been forthright in addressing this concern. We have said repeatedly that there is no one-size-fits-all governance structure, nor is there a one-size-fits-all solution to resolve governance issues. What is needed is a more nuanced view – one more appreciative of the unique facts and circumstances of each organization.

We have provided training to our revenue agents on governance issues and we want them to understand that our concerns about governance are tied to tax code compliance rather than specific governance structures or practices. And we put the training materials on our website so that you know exactly what we're thinking and what we've told our agents.

In addition to recommending uniform training for our agents, the ACT noted that notwithstanding the IRS's contention that good governance leads to compliance, there were no studies that backed that premise. It was, they said, an untested proposition. In response, we undertook our own study to look at the intersection between governance practices and tax compliance as part of the examination program.

We designed a governance checklist and posted it on our website. It mimics Part VI on the Form 990, and it is available to the public on our website. Since October 2009, agents have filled out the governance checklist at the end of every 501(c)(3) public charity exam. This effort generated a lot of data, with checklists from over 1300 cases.

## *Governance Checklist Results*

We then took that data, and gave it to EO Exam and our TE/GE Research function. They worked together to review and analyze it, and today I'm going to share some of their preliminary findings with you. Preliminarily, I need to explain that. This data comes from organizations that were already selected for exam for reasons unrelated to their governance structure. It didn't come from a statistically representative survey of the EO population. So, while I will give you the results from those specific exams, we can't generalize the findings to the EO community as a whole.

The team reviewed the checklists for the organizations, and performed a regression analysis to see if there was a correlation between the answers to certain questions and whether the organization was more compliant or less compliant.

There are 26 questions on the governance check sheet that relate to different governance practices by exempt organizations. The team eliminated the questions where there was a lot of missing data (such as questions that did not apply to all

organizations). They focused the statistical analysis on a few key questions, including these:

- Does the organization have a written mission statement that articulates its current I.R.C. § 501(c)(3) purpose(s)?
- Does the authorized body rely upon comparability data in making compensation determinations?
- Did any of the organization's voting board members have a family relationship and/or outside business relationship with any other voting or non-voting board member, officer, director, trustee, or key employee?
- Does effective control of the organization rest with a single or select few individuals?
- Does the organization have a written conflict of interest policy?
- Are there systems or procedures in place intended to make sure assets are properly used, consistent with the organization's mission?
- Prior to filing, was the Form 990 reviewed by the full board and/or a designated committee?

The analysis found a statistically significant correlation between questions related to some governance practices and tax compliance. What are they? Drum roll please!

- Organizations with a written mission statement are more likely to be compliant,
- Organizations that always use comparability data when making compensation decisions are more likely to be compliant,
- Organizations with procedures in place for the proper use of charitable assets are more likely to be compliant, and
- Organizations where the 990 was reviewed by the entire board of directors are more likely to be compliant. This is an important point and one I'd like to highlight. It indicates that having your entire board engaged in what is being reported on the 990 is not only helpful, but it correlates to better compliance.

On the flip side, among the organizations we examined, we saw that those that said control was concentrated in one individual, or in a small, select group of individuals, were less likely to be tax compliant.

The team also found that responses to some questions had no statistically significant correlation with tax compliance, one way or the other. These include questions relating to:

- Conflict of interest policies
- Organizations that never or only occasionally use comparability data to set compensation, and

- Voting Board members having a family relationship and/or outside business relationship with any other voting or non-voting board member, officer, director, trustee, or key employee

Again, this is an initial analysis, and only of the 501(c)(3) public charities that were already selected for exam based on other criteria. It is not a statistically representative sample or an analysis of the overall population. But it does provide an interesting starting point and offers some insight into which questions and associated responses might be useful indicators of tax compliance.

The results seem to me to be generally consistent with the premise that good governance and tax compliance go hand in hand. But what would be even better than this review, would be one that could verify whether the information from this select group is also true for the general exempt organizations population.

So, I have tasked our strategic planning group to work with TE/GE Research to develop a project proposal to do just that – using a statistically representative sample of the general EO population.

### *Significant Diversion*

We've been talking about governance, including the new Part VI of the redesigned Form 990. Organizations have been filing the redesigned 990 for several years now and that has provided us with a wealth of information on these organizations. We have used this information to develop risk models to assess the likelihood of noncompliance by organizations, allowing more effective use of our examination resources. Holly Paz is going to talk more about risk modeling later when she discusses the EO Work Plan, but this morning I want to focus on a particular piece of information on the 990: the "Significant Diversion of Assets" question in the governance section of the 990 formerly known as "Material Diversion of Assets." (We changed the wording in the 2011 Form 990 to avoid confusion with a similarly worded accounting term.)

Our Review of Operations unit, which we affectionately call the ROO, has done some preliminary research in this area. They looked at the tax filings and publicly available information on the 285 organizations that reported a significant diversion of assets in 2009 and that initial research found the following:

- Roughly \$170 million in significant diversions was identified.
- Many of the cases involved theft or embezzlement, though there were many other cases where the taxpayer didn't explain the significant diversion, as Schedule O requires.
- A handful involved Ponzi schemes.

- 82 cases resulted in civil or criminal charges against the responsible party. These are charges that were brought by the organizations involved, or by local authorities, who were outraged by the activity. They are not IRS charges.
- 47 individuals were incarcerated or served probation for the diversion of the assets. Again, this did not arise from IRS actions
- In 9 cases restitution was paid in full
- In 11 cases there was partial restitution

We are now going to conduct an examination program in this area. While organizations aren't normally selected for exam based on the answer to any particular question on the Form 990, a significant diversion of assets is noteworthy and we need to get a better understanding of these events. By examining these organizations we will be able to identify common indicators of serious cases and common indicators of cases where the organization was able to self-correct. The benefits of this are two-fold: First, as always we will also report out on these results and this will allow us to advise organizations generally on how to avoid these events. Second, it will help us refine our risk models to better target our examination resources.

In many cases like this, an exam will focus narrowly on the details of the transaction. The goal will be to pursue excess benefit transaction actions against the persons committing them. The examination won't necessarily result in tax consequences to the organization itself. In some cases the taxpayer simply didn't provide the required explanation on the Schedule O, and we need to get that missing information. And there are some situations where the taxpayer just did not complete a Schedule O at all.

Going forward, we plan to conduct these examinations to gather more information about the significant diversions and get the information we need to address the excess benefit transactions. We also will determine what internal controls or good governance practices, if any, were present before the significant diversion and whether, and how, they have been added to or modified in response in order to ensure the charities' assets are properly protected in the future.

### *Form 990-N Post Review*

As you can see, the wealth of information from the redesigned 990 is extremely useful, both for compliance and education purposes. However, this usefulness is thwarted if organizations are not filing the right return.

As part of the auto-revocation program, we became aware that some organizations were trying to save themselves from revocation by filing the 990-N e-postcard instead of the 990 they should have been filing.

As I'm sure all of you know, the Pension Protection Act of 2006 made several important changes to the filing system for exempt organizations. First, it established the new filing

requirement for certain small exempt organizations. Organizations can satisfy that requirement by electronically filing the new 990-N, the e-postcard, or by filing one of the other forms - the 990-EZ or the full 990.

The other key provision, which I referred to earlier, is section 6033(j), which automatically revokes an organization's tax-exempt status if it fails to file a required annual return or Form 990-N for three consecutive years. Filing the 990-N does not satisfy this requirement if you exceed the filing thresholds or other requirements for that form, and so would normally be required to file the 990 or 990-EZ.

All of that means that if you are a multimillion dollar organization that has failed to file for a couple of years, and you realize that the deadline is coming up, you might be tempted to just fill out the e-postcard and be done with it. You might think, "ah-ha, I'll just do this and be home free." That is clearly a problem, because not only does this not save an organization from revocation, it means the public loses out on transparency grounds, and we lose one of our most important compliance tools.

This doesn't apply just based on the size of the organization. Some types of organizations, like 509(a)(3) supporting organizations, are not eligible to file the 990-N and need to file a full information return.

Because the 990-N and auto revocation laws were new, the IRS provided transition relief for small organizations by extending the filing due date and creating a voluntary compliance program for EZ filers. Along the way though, we saw that organizations that didn't qualify for the transition relief may have tried to take advantage by filing the 990-N postcard.

We therefore have begun a project to look at two groups of these taxpayers. The first is those that filed a 990-N and another 990 in the same year. We have identified several thousand of these organizations, and we are going to send compliance check letters to about 1,600 of them to determine what prompted that dual filing.

The second group are those that filed the 990-N when it looks like they did not qualify for the 990-N and should have been filing a different return. We've identified nearly a thousand of these by using a variety of information, including employment tax filings and 990-T data. This group also includes the supporting organizations that filed 990-Ns. We are also in the process of sending compliance check questionnaires to these organizations.

As always, we will report out on the results we get here. But remember that these projects take a lot of work and often take longer that you would expect, so stay tuned.



## *Development Process*

Before I wrap up, I wanted to talk briefly about the determination process. Earlier, I mentioned the ACT's important contribution to the governance dialogue. We continue to work closely with them and one of their current projects is the redesign of the Form 1023. In talking with them about that project, and about what I should talk about this morning, they had a lot of questions about the mechanics of our operation and exactly how the determination process works, so I thought I'd take this opportunity to give them, and you, an inside look, and insight into why it can sometimes take longer than one would expect.

Over the last several years we've worked to improve our effectiveness and developed systems that help us focus our resources on the areas where they are most needed.

Our Determinations function gets about 60,000 new applications for tax exemption every year. When I first came to the IRS each one had to wait to be assigned to a revenue agent. Since then, we have developed and put in place a screening system to fast track those applications that are complete and require little or no further development.

You know, and I know, that not all exemption applications are the same. While many are complete when they are received, and involve straight-forward scenarios, others may be incomplete, or they may involve complex issues that require further development. So, a few years ago we improved the development process to better reflect this.

As a first step, all cases go through "technical screening." This is where EO Determinations' most experienced revenue agents take a quick look at each case. They sort of triage each case. They review the applications and separate them into four categories – so you might call it "quadrage":

- Applications that can be approved immediately based on the completeness of the application and the information submitted;
- Applications that need only minor additional required information in the file in order to approve the application;
- Applications that do not contain the information needed to be considered substantially complete; and
- Applications that require further development by an agent in order to determine whether the application meets the requirements for tax-exempt status.

That fourth category is the one that is most complex. People often have questions about how the development process works, so let me spend a few minutes on that. We send letters to organizations whose applications fall into that fourth category informing them that their application needs more development, and that we will contact them once we have assigned their application to a revenue agent. We hold these applications in unassigned inventory, until a revenue agent, with the appropriate level of experience for

the issues involved, has an opening in his or her caseload. Sometimes this takes longer than any of us would like, and my apologies for that.

When the case is assigned, the revenue agent notifies the organization, reviews the application, and requests whatever additional information and documentation he or she needs to make the determination. Those requests, or development letters, serve multiple functions and are helpful both to the organization and to the IRS. We put requested response dates on our development letters to try to keep the process moving, but if organizations need more time to gather their information and respond, they can always request that time. The same goes for questions that the organization thinks they can respond to differently than requested. This back and forth dialogue helps applicants better understand the requirements for exemption and what is needed to meet them, and it helps the IRS understand the application and obtain all the information relevant to the determination.

This also builds what is called the “administrative record.” That’s important because if the case ends up going to appeals or to court, it will be decided based on the facts in the administrative record. So, both parties need to make sure everything relevant is included. That is also why everything needs to be submitted on paper, so that we can go back and look at exactly what was considered. But, hopefully the process never comes to that. Either the organization ends up qualifying, or, after gaining a better understanding of the exemption requirements, it realizes it either does not need or does not want to pursue recognition of tax exemption.

The screening process had helped us to reduce a continual large backlog of cases. Lately, however, you may have noticed longer delays in getting your cases assigned for full development. This is due, in part, to organizations that were automatically revoked and are re-applying for recognition of exemption. Although we expected that many small organizations would take advantage of the transition relief and seek retroactive reinstatement, we have been surprised at the number of large organizations that have applied based on reasonable cause for not filing for three years. These cases take time, but we are working through them the best we can.

## *Conclusion*

I hope this has given you a taste of what goes on “behind the veil,” and I’ve enjoyed sharing it with you. We’ve covered many different topics this morning, but that is what my office has to do on a daily basis. Regulating a sector this diverse is nothing if not interesting.

Thank you again, Celia, for the invitation to appear here today. And thanks to all of you attending this conference. I hope you’ve enjoyed your peek into my world at the IRS.