

**Improvements Are Needed in the Exempt
Organizations Compliance Unit to Better
Support the Exempt Organizations Function's
Overall Strategic Goals**

May 2005

Reference Number: 2005-10-078

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.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

May 27, 2005

MEMORANDUM FOR COMMISSIONER, TAX EXEMPT AND GOVERNMENT
ENTITIES DIVISION

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Improvements Are Needed in the Exempt
Organizations Compliance Unit to Better Support the Exempt
Organizations Function's Overall Strategic Goals
(Audit # 200410036)

This report presents the results of our review of the adequacy of the Exempt Organizations (EO) function's efforts to implement the Exempt Organizations Compliance Unit (EOCU) and whether the EO function had controls to effectively manage EOCU projects. Public concerns about exempt organizations' operations and compliance have brought increased attention from the press and oversight bodies regarding the accuracy of EO function customer account data and the declining level of enforcement activities across the Internal Revenue Service. In response to the increased public scrutiny, the EO function established the EOCU in January 2004. The EOCU is designed to address noncompliance by using correspondence and telephone contacts to correct return information.

In summary, the initial EOCU projects were conducted in accordance with management's goals of increasing contacts in the exempt organizations community and improving the accuracy of tax return information. However, the initial projects were not based on data analysis of noncompliance issues and did not always relate to the most critical EO function initiatives. Improvements are needed to ensure management identifies and prioritizes future EOCU projects that are focused on the EO function's highest priority areas. EO function management planned to have EOCU projects identified by the Data Analysis Unit (DAU), which is designed to conduct data analysis to identify work projects with a high risk of compliance problems, but the DAU was not operational when the EOCU was initially established. In addition, the EOCU manager stated that another source of EOCU projects will be the various EO function compliance

and market segment projects. These projects may also provide a significant amount of research on the noncompliance areas for the proposed EOCU projects.

EO function management should establish procedures that detail the documentation and research needed to plan EOCU case work to enable projects to be completed timely and efficiently. This guidance is necessary to ensure a consistent process is followed by EO function personnel when planning EOCU case work. Additionally, adequate project planning documentation will help EO function management prioritize the projects that best support the EO function's strategic goals and not overlook good project ideas because of insufficient documentation.

Further, improvements are needed to more effectively track case results. Specifically, additional codes should be added to the inventory system to better track project results when EOCU cases are closed. We identified 249 cases closed as of September 16, 2004, in which EOCU employees selected the disposal code "Other" to indicate the final case outcome. In the 242 cases¹ for which sufficient information was captured on the database, we determined many cases had similar results that could be better tracked by EO function management through additional disposal codes. During our fieldwork, we informed EO function management of the need for additional codes to better track EOCU case results. As a result, EO function management has taken action to create additional codes and increase EOCU employees' awareness in this area. Therefore, we are making no further recommendations to address this issue.

In addition, EO function management should establish specific timeliness standards for EOCU case processing to ensure cases are completed timely. We determined EOCU management had started developing a quality measurement system for EOCU projects before we started our audit. However, our review of the draft guidelines showed that the timeliness standards are subjective and general in nature. Specifically, there is no guidance indicating what is considered a reasonable or appropriate time period in which to complete EOCU case work.

We recommended the Director, EO, develop a process to identify and prioritize future EOCU case work based primarily on data analysis, develop procedures that specify the documentation required for future EOCU projects, and develop specific timeliness standards for processing certain EOCU case work.

Management's Response: The Commissioner, Tax Exempt and Government Entities Division, agreed with our recommendations and plans to take corrective action. The Director, EO Examination, will ensure the development of a structured process to identify and prioritize future EOCU case work; ensure the development of detailed guidance that specifies the documentation necessary for planning, developing and obtaining approval for future EOCU projects; and develop timeliness standards for applicable EOCU cases. Management's complete response to the draft report is included as Appendix V.

¹ In seven cases, there was insufficient information on the database with which to determine the case disposition.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at 202-622-8500.

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Support the Exempt Organizations Function’s Overall Strategic Goals**

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Improvements Are Needed in the Exempt Organizations Compliance Unit to Better Support the Exempt Organizations Function's Overall Strategic Goals

Background

In recent years, there has been a significant growth in the number of entities recognized as exempt from Federal income tax under the Internal Revenue Code (I.R.C.). In Fiscal Year (FY) 2003, there were 1.6 million exempt organizations, compared to 1.1 million in FY 1993. However, there has been a significant reduction in resources dedicated by the Tax Exempt and Government Entities (TE/GE) Division to examinations of these entities, resulting in a sharp decline in examination coverage. Examinations fell from approximately 12,300 in FY 1993 to less than 5,800 in FY 2003.

The Exempt Organizations (EO) function of the TE/GE Division has responsibility for ensuring compliance with the I.R.C. sections and regulations that govern organizations exempt from Federal income tax. Public concerns about organizations' operations and compliance have brought increased attention from the press and oversight bodies regarding the accuracy of EO function customer account data and the declining level of enforcement activities across the Internal Revenue Service (IRS). As a result, EO function management has continued to emphasize enforcement in FY 2005 to slow the growth of abuses in the tax exempt community and promote voluntary compliance. Additionally, the IRS Commissioner testified before the Congress that enforcement within the tax exempt community is a priority in FY 2005.

In response to the increased public scrutiny, the EO function established an Exempt Organizations Compliance Unit (EOCU) in January 2004. The Unit is designed to address noncompliance by using correspondence and telephone contacts to correct return information. The EOCU's goal is to contact a greater number of exempt organizations than would be possible through traditional examinations, thereby enabling EO Examinations function personnel to concentrate on the examinations work requiring face-to-face contacts.

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Since its inception, the EOCU has conducted compliance checks,¹ educational mail-outs, and case building projects.² From January 2004 through early January 2005, the EOCU closed approximately 10,000 cases. Currently, the EOCU is approved for a staff of 14 technical employees and 1 manager. In FY 2005, the EO function plans to hire an additional 20 employees to perform EOCU work.

This review was performed in the EOCU located at the Ogden Campus³ in Ogden, Utah, during the period September through November 2004 in accordance with *Government Auditing Standards*. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The Exempt Organizations Function Could Better Plan and Prioritize Projects

The initial EOCU projects were conducted in accordance with management's goals of increasing contacts in the exempt organizations community and improving the accuracy of tax return information. However, the initial projects were not based on data analysis of noncompliance issues and did not always relate to the most critical EO function initiatives. Improvements are needed to ensure management identifies and prioritizes future EOCU projects that are focused on the EO function's highest priority areas. In addition, EO function management should establish procedures that detail the documentation and research needed to plan EOCU case work to enable projects to be completed timely and efficiently.

¹ A compliance check is a contact with the customer that involves a review of filed information and tax returns of the entity to determine whether the entity is adhering to record keeping and information reporting requirements. A compliance check is not an examination, and the customer may legally choose not to participate in the compliance check.

² Case building involves sending out letters at the request of an EO function employee to a small sample of taxpayers to obtain information for a possible compliance project.

³ The campuses are the data processing arm of the IRS. They process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

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A structured process is needed to identify and prioritize EOCU work projects that will best support the strategic goals of the EO function

One of the EO function's top priorities in FY 2005 is building a stronger enforcement presence by increasing the number of compliance contacts within the exempt organizations community. We believe these contacts should be in the high-priority, high-visibility noncompliance areas so customers realize the EO function is increasing its monitoring of the exempt organizations community.

However, EO function management has not established a project development process to identify the highest priority work for the EOCU based primarily on data analysis of noncompliance trends. Instead, a list of project ideas was developed in March 2003, during two meetings held in Washington, D.C. For FYs 2004 and 2005, the projects planned for the EOCU have primarily come from the ideas developed at these meetings. While these ideas may have had merit, without data analysis to determine the potential size of the noncompliance problem, EO function management did not always identify projects related to the most critical EO function initiatives. For example, one project initially planned for the EOCU related to the compliance of kennel clubs. The Director, EO, subsequently decided not to initiate an EOCU project in this area and revised the FY 2005 workplan.

Some of the initial ideas were in high-priority areas and served to increase the EO function's enforcement presence. For example, several excess compensation initiatives and an insurance organization project have been conducted by the EOCU. Both of these topics have been a priority within the EO function.

EO function management agreed that the initial projects performed in the EOCU were not based on data analysis of high-risk areas of noncompliance. Less-technical projects were initially performed due to the inexperience of the EOCU staff members, who were new to the EO function. In addition, EO function management planned to have EOCU projects identified by the Data Analysis Unit (DAU), which is designed to conduct data analysis to identify work projects with a high risk of compliance problems. However,

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the DAU was not operational when the EOCU was initially established. Finally, the EOCU manager stated that another source of EOCU projects will be the various EO function compliance and market segment projects. These projects may also provide a significant amount of research on the noncompliance areas for the proposed EOCU projects.

Although these two sources should provide a better basis for EO function management to evaluate project proposals, there is still a need to prioritize the EOCU work projects that best support the EO function's overall strategic goals. This is especially important in light of EO function management's plans to increase the role of the EOCU as part of the EO function's enforcement program. Specifically, EO function management recently submitted a request for an increase in staffing in FY 2007 to allow the Unit to support EO function critical initiatives and provide broad-based coverage to the exempt organizations community. Based on our review of this request, EO function management plans to have the EOCU perform single-issue audits that can be completed through written correspondence instead of face-to-face contact by EO Examinations function personnel.

EO function management should establish procedures detailing the information necessary for planning EOCU projects

At the time of our review, no formal guidance had been prepared for planning and developing a project prior to submitting it to the EOCU. This guidance is necessary to ensure a consistent process is followed by EO function personnel when planning EOCU case work. Additionally, adequate project planning documentation will help EO function management prioritize the projects that best support the EO function's strategic goals and not overlook good project ideas because of insufficient documentation. We believe the project documentation should contain sufficient information about the extent of the noncompliance problem and why it would be an appropriate use of EOCU resources to conduct the project. It is also important to note that EOCU personnel do not perform additional research on the noncompliance issue once they start the project. The EO function personnel submitting the project idea must provide

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a description of the noncompliance issue and why further contact with customers is needed. If the project idea is selected, the same personnel also prepare the various project plans and instructions for the EOCU to carry out the project.

After the initial EOCU project ideas were identified, a three-person team prioritized the projects and prepared documentation for each project selected for implementation. Based on our review of project documentation for three selected projects⁴ and interviews with EOCU management, we determined that a Procedure document, which provided guidance for completing specific project tasks, was prepared for the selected projects. In addition, for the compliance check and educational mail-out projects, the following additional documentation was prepared:

- Project Proposal, which outlined the project objectives, effect on customer service, potential project outcomes, staffing requirements, etc.
- Approach document, which provided specific information on the project population, case research steps, and an overview of steps for completing a case.
- Customer Account Services Briefing document, which provided guidance to TE/GE Division Customer Account Services function personnel in answering any questions received from taxpayers regarding EOCU projects.
- Just-In-Time Training, which outlined the background and tax laws necessary for EOCU employees to complete the project.

This documentation was also developed for the other initial EOCU projects, according to an EO function manager. For future projects, EO function management plans to have the project originator prepare this documentation. However, without specific guidance on what is required, EO function personnel may not know what documentation to submit for

⁴ We selected the Fundraising Educational Mail-Out project, one of the Foundation Code/Subsection Code Mismatch compliance check projects, and the Zero Compensation Paid to Officers case building project.

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future EOCU projects. As stated earlier, this may hamper EO function management's ability to identify the highest priority projects that would be the best use of EOCU resources and would provide insufficient guidance for the EOCU to carry out the projects timely and efficiently.

Recommendations

The Director, EO, should:

1. Develop a structured process that identifies and prioritizes future EOCU case work based primarily on data analysis to assist management in selecting the highest priority projects that are the best use of EOCU resources.

Management's Response: The Director, EO Examination, will develop a structured process to identify and prioritize future EOCU case work based primarily on data analysis.

2. Prepare detailed guidance that specifies the documentation that should be completed for planning, developing, and obtaining approval for future EOCU projects and communicate it to applicable EO function personnel.

Management's Response: The Director, EO Examination, will prepare guidance that specifies the documentation that should be completed for planning, developing, and obtaining approval for future EOCU projects, and communicate it as appropriate within the EO function.

Based on interviews with EO function management, we determined the EOCU has a process to assign and close cases selected as part of EOCU projects. However, improvements are needed to more effectively track case results. Specifically, additional codes should be added to the inventory system to better track project results when EOCU cases are closed. In addition, EO function management should establish specific timeliness standards for EOCU case processing to ensure cases are completed timely.

Additional Disposal Codes and Timeliness Standards Are Needed to Evaluate Exempt Organizations Compliance Unit Project Results

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Enhanced use of disposal codes on the EOCU database would better track project results

Currently, EOCU management tracks all projects on a stand-alone Microsoft Access[®] database. This database is used to control the inventory of cases for each EOCU project.

When a case is completed, EOCU personnel update the EOCU database to reflect the case closing and the applicable case results by selecting a disposal code. We identified 249 cases closed as of September 16, 2004, in which EOCU employees selected the disposal code "Other" to indicate the final case outcome. In the 242 cases⁵ for which sufficient information was captured on the database, we determined many cases had similar results that could be better tracked by EO function management through additional disposal codes. For example, we determined 115 cases related to case building projects in which the EOCU sent letters to taxpayers and then closed the cases after the taxpayers responded. We also identified 46 cases for which EOCU personnel performed research and then closed the cases due to the low dollar amounts involved. EO function management had not created specific codes on the EOCU database to document these types of case closings.

Additionally, we identified 11 of the 242 cases in which EOCU employees used the "Other" disposal code when a more descriptive disposal code was available. For example, in nine cases, EOCU employees' comments indicated that the exempt organizations had complied with filing and/or reporting requirements, resulting in no changes based upon the case work. However, the employees should have selected disposal code "Inquiry resolved – accepted explanation" that more accurately and clearly identified the outcomes of these cases. This disposal code is to be used when a case results in no change to the return or to the taxpayer's account.

There is little oversight over the input of disposal codes to the system. EOCU procedures instruct employees to update

⁵ In seven cases, there was insufficient information on the database with which to determine the case disposition.

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the database with the appropriate disposal code upon completion of the case work. However, EOCU management reviews only one closed case per employee per month due to the high volume of cases closed in the Unit. The Lead Tax Examiner reviews one closed case per employee per week. Due to the low number of case reviews performed, concerns with the use of disposal codes may not be readily identified by management during its quality review process. EO function management stated they had not previously identified this issue.

EOCU personnel prepare reports to document the results of many of their projects, including the impact the projects had on exempt organizations' compliance. Sufficient and accurate information about the disposition of cases is needed if the EOCU is to effectively evaluate the results of its projects.

During our fieldwork, we informed EO function management of the need for additional disposal codes to better track EOCU case results. As a result, EO function management has taken action to create additional disposal codes and increase EOCU employees' awareness in this area. Specifically, EOCU personnel performed an analysis of all the cases closed using the "Other" disposal code as of December 9, 2004, and changed the dispositions to newly added, more descriptive codes or to existing codes that better described the case dispositions. Based upon this analysis, EO function management corrected 432 cases that were closed using the "Other" disposal code. As a result, we are making no further recommendations to address this issue.

Specific timeliness standards are needed to measure EOCU case work

We determined EOCU management had started developing a quality measurement system for EOCU projects before we started our audit. However, our review of the draft guidelines showed that the timeliness standards are subjective and general in nature. Specifically, there is no guidance indicating what is considered a reasonable or appropriate time period in which to complete EOCU case work. For example, one standard is, "Was the compliance check and/or examination started (or reassigned) within a

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reasonable timeframe?" Another asks, "Was the length of research time appropriate for the issue?" As a result, there may be varying opinions on whether these standards were met.

EOCU management stated they were not planning to develop specific timeliness standards. They do not consider EOCU case work "measured work" that requires specific timeliness standards. However, we determined the EO Examinations function has specific guidelines for how long certain tasks should take when processing similar types of compliance work. For example, specific timeliness standards have been established for correspondence examinations performed by EO function personnel. In addition, the TE/GE Division Federal, State, and Local Governments function has developed a separate Internal Revenue Manual for completing compliance checks that includes several of the same timeliness standards found in the EO Examinations function guidance. The timeliness standards from these other functions could be used as a guide to develop specific timeliness standards for the EOCU. Without established standards, there is a risk that EOCU case processing may not be completed as timely as possible and may increase taxpayer burden.

Recommendation

3. The Director, EO, should develop specific timeliness standards for applicable EOCU cases to ensure they are completed timely.

Management's Response: The Director, EO Examination, will develop specific timeliness standards for applicable EOCU cases.

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Appendix I

Detailed Objectives, Scope, and Methodology

The overall objectives of this review were to determine the adequacy of the Exempt Organizations (EO) function's efforts to implement the Exempt Organizations Compliance Unit (EOCU) and whether the EO function had controls to effectively manage EOCU projects. To accomplish our objectives, we:

- I. Assessed whether EO function management had developed plans to achieve the goals developed for the EOCU.
 - A. Interviewed EO function management to determine their goals for the EOCU.
 - B. Obtained any documentation developed by EO function management used to justify the establishment of the EOCU and obtain additional resources.
 - C. Assessed EOCU management's strategic planning efforts to ensure projects planned or ongoing are properly coordinated to assist management in achieving EOCU goals (both short-term and long-term).
- II. Determined whether the EO function had the necessary management information to monitor and evaluate the productivity and effectiveness of the EOCU.
 - A. Determined whether key data were captured to allow management to effectively monitor and evaluate the effectiveness of the EOCU program.
 - B. Determined whether there was a process in place to analyze project results and to use the results in planning future projects.
 - C. Determined whether any performance measures had been developed for the EOCU.
- III. Assessed the process used to identify, prioritize, and select EOCU work projects for compliance and educational purposes.
 - A. Determined the methodology used to identify EOCU work projects.
 - B. Determined whether an adequate process had been implemented to prioritize and select EOCU work projects.
 - C. Determined whether all necessary planning documentation had been developed and approved for our sampled work projects. We judgmentally sampled 3 of the 13 EOCU projects (the Fundraising Educational Mail-Out project, one of the Foundation Code/Subsection Code Mismatch compliance check projects, and the Zero Compensation Paid to Officers case-building projects) initiated during the period February through August 2004. We used a judgmental sample due to time constraints and because we did not plan to project our results.

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- IV. Assessed the process used to manage the sampled EOCU projects from Sub-objective III.C.
- A. Determined the process used to select EOCU cases for each sampled project.
 - B. Determined whether an adequate process had been implemented to prioritize and assign EOCU cases for each sampled project.
 - C. Determined whether an effective process was in place to monitor case workload to ensure cases were timely worked for each sampled project.
 - D. Determined the process used to close EOCU cases and finalize the sampled projects.

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Appendix II

Major Contributors to This Report

Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs)

Nancy A. Nakamura, Director

Jeffrey M. Jones, Audit Manager

Cheryl Medina, Lead Auditor

Michael Van Nevel, Senior Auditor

Michael McGovern, Auditor

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Appendix III

Report Distribution List

Commissioner C
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Deputy Commissioner for Services and Enforcement SE
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Director, Exempt Organizations, Tax Exempt and Government Entities Division SE:T:EO
Chief Counsel CC
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Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
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Division SE:T:CL

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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Reliability of Information - Actual; 432 cases (see page 6).

Methodology Used to Measure the Reported Benefit:

We queried the Exempt Organizations Compliance Unit (EOCU) inventory database for cases closed with the disposal code “Other” as of September 16, 2004, and identified 249 cases. In the 242 cases¹ for which sufficient information was captured on the database, we determined many cases had similar results that could be better tracked by Exempt Organizations (EO) function management through additional disposal codes. In addition, EOCU employees used the “Other” disposal code to close some cases when a more descriptive disposal code was available.

During our fieldwork, we informed EO function management of the need for additional disposal codes to better track EOCU case results. As a result, EO function management has taken action to create additional disposal codes and increase EOCU employees’ awareness in this area. Specifically, EOCU personnel performed an analysis of all the cases closed using the “Other” disposal code as of December 9, 2004, and changed the dispositions to newly added, more descriptive codes or to existing codes that better described the case dispositions. Based upon this analysis, EO function management corrected 432 cases that were closed using the “Other” disposal code.

¹ In seven cases, there was insufficient information on the database with which to determine the case disposition.

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Appendix V

Management's Response to the Draft Report



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

RECEIVED
MAY 18 2005

MAY 18 2005

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: 
Steven T. Miller
Commissioner, Tax Exempt and Government Entities

SUBJECT: Response to Draft Audit Report: Improvements are needed in the Exempt Organizations Compliance Unit to better support the Exempt Organizations Function's Overall Strategic Goals (Audit # 200410036)

I am pleased to respond to your draft audit report ("report") on the Exempt Organizations Compliance Unit (EOCU).

The EOCU is a new organization designed, in part, to increase the IRS' enforcement presence in the exempt organizations community. The EOCU has been in operation a little over a year, and we believe it is starting to make a significant contribution to compliance in the exempt organizations area. For example, thus far in FY 2005, the EOCU has sent out 16,484 educational letters, and conducted 2,444 compliance contacts.

We appreciate your careful observations about our new unit and your suggestions for ways to make it more efficient, effective, uniform and successful. We intend to implement each of your three suggestions. We also concur in your estimate of the benefit your recommendations will provide, as set out in Appendix IV of your report.

Our response to the recommendations in your report follows:

IDENTITY OF RECOMMENDATION 1

The Director, EO, should develop a structured process that identifies and prioritizes future EOCU case work based primarily on data analysis to assist management in selecting the highest priority projects that are the best use of EOCU resources.

CORRECTIVE ACTIONS

The Director, EO Examination will ensure that a structured process is developed that identifies and prioritizes future EOCU case work based primarily on data analysis.

IMPLEMENTATION DATE

January 15, 2006

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RESPONSIBLE OFFICIALS

Director, EO Examination

CORRECTIVE ACTION MONITORING PLAN

The Director, EO Examination will report to the Director, EO on progress toward establishing the referenced process.

IDENTITY OF RECOMMENDATION 2

The Director, EO, should prepare detailed guidance that specifies the documentation that should be completed for planning, developing, and obtaining approval for future EOCU projects and communicate it to applicable EO function personnel.

CORRECTIVE ACTION

The Director, EO Examination will ensure that guidance is prepared that specifies the documentation that should be completed for planning, developing, and obtaining approval for future EOCU projects, and will ensure that it is communicated as appropriate within EO.

IMPLEMENTATION DATE

March 31, 2006

RESPONSIBLE OFFICIALS

Director, EO Examination

CORRECTIVE ACTION MONITORING PLAN

The Director, EO Examination will report to the Director, EO on the progress of the referenced EOCU guidance.

IDENTITY OF RECOMMENDATION 3

The Director, EO should develop specific timeliness standards for applicable EOCU cases to ensure they are completed timely.

CORRECTIVE ACTION

The Director, EO Examination will develop specific timeliness standards for applicable EOCU cases.

IMPLEMENTATION DATE

January 15, 2006.

RESPONSIBLE OFFICIALS

Director, EO Examination

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CORRECTIVE ACTION MONITORING PLAN

The Director, EO Examination will report to the Director, EO on the progress of the referenced timeliness standards.

If you have any questions, please contact Mike Daly at (202) 283-9964.