



*Some Tax-Exempt Organizations Have
Substantial Delinquent Payroll Taxes*

July 3, 2014

Reference Number: 2014-10-012

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.

Redaction Legend:

1 = Tax Return/Return Information

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HIGHLIGHTS

SOME TAX-EXEMPT ORGANIZATIONS HAVE SUBSTANTIAL DELINQUENT PAYROLL TAXES

Highlights

Final Report issued on July 3, 2014

Highlights of Reference Number: 2014-10-012 to the Internal Revenue Service Commissioner for the Tax Exempt and Government Entities Division.

IMPACT ON TAXPAYERS

While tax-exempt organizations are generally not required to pay income taxes, they are generally required to pay other taxes such as payroll taxes. Tax-exempt organizations that do not pay their taxes result in millions of dollars in lost tax revenue.

WHY TIGTA DID THE AUDIT

The overall objectives of this review were to determine if, and to what extent, tax-exempt organizations have known Federal tax debt and to identify actions the Exempt Organizations function has taken to address this noncompliance.

WHAT TIGTA FOUND

IRS records indicate that the majority of tax-exempt organizations pay their Federal taxes. However, a small percentage are not paying their taxes. More than 64,200 (3.8 percent) tax-exempt organizations had nearly \$875 million of Federal tax debt as of June 16, 2012. While some organizations owed minor amounts, approximately 1,200 tax-exempt organizations owed more than \$100,000 each. Unpaid taxes were often associated with multiple tax periods. For example, nine organizations each had Federal tax debt spanning 10 or more years that collectively totaled more than \$5.5 million.

TIGTA reviewed 25 tax-exempt organizations—under Internal Revenue Code § 501(c)(3)—that appeared to be among the worst examples involving unpaid Federal tax (but not representative of the population of all

tax-exempt organizations with unpaid tax). These organizations generally received government payments over a three-year period of \$148 million, including Medicare, Medicaid, and government grants; had annual revenue of almost \$167 million; and owned assets of more than \$97 million, but continued to not remit payroll and other taxes, including penalties and interest, totaling more than \$25 million.

The Internal Revenue Code does not authorize the IRS to revoke tax-exempt status based on an organization's failure to pay payroll taxes, and most of the organizations that TIGTA reviewed were still recognized by the IRS as tax-exempt as of May 2013. The Exempt Organizations function had completed several examinations but was generally not aware of the behavior of the organizations because another IRS business unit is responsible for collecting the delinquent tax debt.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Director, Exempt Organizations: 1) coordinate with Small Business/Self-Employed Division management to receive relevant collection information, 2) periodically complete analyses to identify tax-exempt organizations that potentially abuse their tax-exempt status for examination (if necessary), and 3) work with the Department of the Treasury to evaluate whether a legislative proposal is warranted to strengthen the IRS's ability to enforce payroll tax noncompliance by tax-exempt organizations.

In their response to the report, IRS management disagreed with the first two recommendations and agreed to apprise the Department of the Treasury of our third recommendation. TIGTA believes that the Exempt Organizations function should do more to oversee tax-exempt organizations that repeatedly fail to remit payroll taxes, which include Medicare, Social Security, and Federal income taxes withheld from employees. This is particularly important since these organizations have the benefit of charitable status, and the Government has paid them millions of dollars of Medicare and Medicaid funds.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

July 3, 2014

MEMORANDUM FOR OFFICE OF THE DEPUTY COMMISSIONER FOR
SERVICES AND ENFORCEMENT

FROM: Michael E. McKenney
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Some Tax-Exempt Organizations Have
Substantial Delinquent Payroll Taxes (Audit # 201310026)

This report presents the results of our review on tax-exempt organizations having substantial delinquent payroll taxes. The overall objectives of this review were to determine if, and to what extent, tax-exempt organizations have known Federal tax debt and to identify actions the Exempt Organizations function has taken to address this noncompliance. This audit is included in our Fiscal Year 2014 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

Management's complete response to the draft report is included as Appendix VIII. We have concerns about the accuracy of certain statements in the IRS's response to our report. We have noted these concerns in Appendix IX.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. If you have any questions, please contact me or Gregory D. Kutz, Assistant Inspector General for Audit (Management Services and Exempt Organizations).



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Abbreviations

EO	Exempt Organizations
GAO	Government Accountability Office
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
TIGTA	Treasury Inspector General for Tax Administration



Some Tax-Exempt Organizations Have Substantial Delinquent Payroll Taxes

Background

The Internal Revenue Service (IRS) reported a net Tax Gap¹ of \$385 billion as of Tax Year 2006.² The Tax Gap is defined as the amount of tax liability owed by taxpayers that is not paid on time. A significant portion of this Tax Gap involves taxpayers that do not report and pay all the payroll taxes they owe (\$72 billion) as well as taxpayers that do report the payroll taxes they owe but do not pay them (\$4 billion). Part of this is attributable to organizations that are exempt from paying income tax under Section (§) 501(a) of the Internal Revenue Code (I.R.C.)³ but are generally responsible for payroll and certain other taxes.

Part of the \$385 billion net Tax Gap can be attributed to unreported or unpaid Federal payroll taxes.

IRS data indicates that nearly 1.7 million organizations in various classifications are currently recognized as being tax exempt. Charitable organizations (I.R.C. § 501(c)(3)) constitute the largest classification, accounting for almost 67 percent of all tax-exempt organizations.⁴ Other classifications of tax-exempt organizations include civic and business leagues, labor organizations, recreational clubs, domestic fraternal societies, and credit unions.⁵ Differences between the various classifications include whether donations to the tax-exempt organizations are tax deductible and whether tax-exempt organizations are required to submit an application to the IRS for recognition of their tax-exempt status. For example, donations to certain tax-exempt organizations, such as charitable organizations, certain veteran's organizations, and certain cemetery companies, are deductible on the donor's individual tax return.⁶ However, donations to other organizations are not deductible.

Organizations seeking deductible donations, with the exception of churches and certain small organizations, must apply with the IRS, which then determines whether the request for tax-exempt status should be granted.⁷ Generally, each tax-exempt organization is required to file

¹ See Appendix VII for a glossary of terms.

² This is the latest data the IRS has available.

³ I.R.C. § 501(a) grants an exemption from Federal income taxes to organizations that meet certain requirements in I.R.C. § 501(c) or (d). Other sections of the I.R.C. also exempt certain organizations from Federal income taxes, including § 527.

⁴ Information on the number of tax-exempt organizations was obtained from the IRS's Exempt Organizations Master File as of December 2012, and the percentage classified under I.R.C. § 501(c)(3) was obtained from the IRS's Statistics of Income Division as of September 2012.

⁵ See Appendix IV for a list of types of I.R.C. § 501(c) tax-exempt organizations.

⁶ I.R.C. § 170.

⁷ I.R.C. § 508(a).



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an annual information return or notice⁸ that provides the IRS with information about the organization, operations, officers, and directors. A tax-exempt organization's annual information return also provides the public with key information about the organization.

Similar to for-profit employers, tax-exempt organizations with compensated employees are required to pay payroll taxes that are withheld from employees' wages "in trust" for the Federal Government as well as other applicable Federal taxes. Payroll taxes required to be withheld from employees by the tax-exempt organization generally consist of income taxes;⁹ Old Age, Survivors, and Disability Insurance, commonly referred to as Social Security; and Medicare.¹⁰ To the extent that these payroll taxes are withheld and not forwarded to the IRS, individuals within the business (*e.g.*, tax-exempt organization officials) may be held personally liable. They can also be assessed a civil monetary penalty known as a Trust Fund Recovery Penalty.¹¹ Willful failure to remit payroll taxes is a felony under U.S. law, punishable by a fine, imprisonment, or both, and the failure to properly segregate payroll taxes can be a criminal misdemeanor offense.¹²

A Fiscal Year 2008 Government Accountability Office (GAO) report¹³ indicated that "while most businesses fulfill their fiduciary responsibility to the government to withhold taxes from their employee's salaries, make matching contributions, and remit these sums to the government, a significant number do not. As of September 30, 2007, IRS's records showed that more than 1.6 million businesses owed more than \$58 billion in unpaid payroll taxes, including interest and penalties."

In addition, a GAO report issued in June 2007¹⁴ stated that while most tax-exempt organizations appeared to pay their Federal taxes, tens of thousands abused the Federal tax system. The GAO's analysis determined that approximately 55,000 (3.1 percent) of the nearly 1.8 million tax-exempt organizations owed almost \$1 billion in Federal tax debt.

⁸ See Appendix VI for a list of tax and wage forms cited in this report. Tax-exempt organizations are required to file IRS Form 990, Form 990-EZ, or Form 990-N. Churches and certain other tax-exempt organizations with less than \$50,000 in annual revenues are not required to file.

⁹ I.R.C. § 3402.

¹⁰ Social Security is taxed at 6.2 percent on the first \$113,700, and Medicare is taxed at 1.45 percent with no income cap. Tax rates and wage limits are as of Tax Year 2013. Employers are also taxed, at the same rates, for Social Security and Medicare on employee wages.

¹¹ I.R.C. § 6672.

¹² I.R.C. §§ 7202, 7215, and 7512(b).

¹³ GAO, GAO-08-617, *Tax Compliance: Businesses Owe Billions in Federal Payroll Taxes* (July 2008). The number reported by the GAO is total unpaid payroll taxes. This includes all balance due accounts for which collection statutes (generally 10 years) have not expired.

¹⁴ GAO, GAO-07-563, *Thousands of Organizations Exempt from Federal Income Tax Owe Nearly \$1 Billion in Payroll and Other Taxes* (June 2007).



Some Tax-Exempt Organizations Have Substantial Delinquent Payroll Taxes

- Approximately 1,500 tax-exempt organizations owed more than \$100,000 each, which accounted for \$600 million of the \$1 billion, with some owing more than \$10 million each.
- Twenty-five tax-exempt organizations and top officials investigated were involved in abusive activity including: 1) repeated failure to remit payroll taxes withheld from employees; 2) diversion of money to fund their operations, including paying top officials large salaries ranging from hundreds of thousands of dollars to more than \$1 million while the officials accumulated substantial assets such as million-dollar homes and luxury vehicles; and 3) criminal activities committed by key officials and employees, including attempted bribery of an IRS official and illegal gambling.

In addition to not paying payroll and other taxes, the GAO found that more than 1,200 tax-exempt organizations with unpaid payroll and other taxes received more than \$14 billion in direct Federal grants in Fiscal Years 2005 and 2006. Grant applicants that apply directly to the Federal Government are required to complete Standard Form 424, *Application for Federal Assistance*, which requires applicants to certify whether they are delinquent on any Federal debt, including Federal tax debt.

In response to the June 2007 GAO report, IRS management stated that the IRS would enhance tax-exempt organizations' tax compliance efforts by analyzing discrepancies between payroll tax data reported to the Social Security Administration and data reported to the IRS and by piloting a new modeling program to identify tax-exempt organizations with a high risk of payroll tax noncompliance.

The IRS maintains a file of all "unpaid assessments." These unpaid assessments are legally enforceable claims against taxpayers and consist of taxes, penalties, and interest that have not been paid or abated. For the purposes of this report, we refer to these unpaid assessments as Federal tax debts. These Federal tax debts are generally created when a taxpayer files a return without full payment, an IRS audit identifies additional amounts owed, or the IRS makes adjustments to correct inaccuracies on a return. In addition, a Federal tax debt can be identified as a part of IRS enforcement programs. These enforcement programs generally identify taxpayers who fail to file or timely file required Federal returns, accurately report their taxes, or voluntarily pay the amount of taxes due. The IRS classifies its total Federal tax debt inventory into the following four categories:

- **Taxes receivable:** Assessments that are self-assessed by the taxpayer, an agreed examination, a court ruling in favor of the IRS, *etc.*
- **Compliance:** Assessments not agreed to by the taxpayer.
- **Write-Offs:** Assessments that the IRS still has the statutory authority to collect but for which there is no collection potential.



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- Memo: Assessments that are not receivables according to Federal financial standards, including duplicate assessments, assessments due to a fraudulent return filed by a taxpayer, assessments involving many tax periods with related or intermingled issues, and instances in which an examination/appeal will not be resolved for more than one year.

Under Federal accounting standards, Federal tax debts require taxpayer or court agreement to be considered Federal tax receivables. Because of this distinction, when we refer to Federal tax debts in this report, we are referring to those debts that require taxpayer or court agreement that are classified by the IRS as taxes receivable as well as write-offs. Compliance and memo assessments are not considered Federal taxes receivable because they have not been agreed to by the taxpayers or the courts.

The Exempt Organizations (EO) function of the IRS Tax Exempt and Government Entities Division is responsible for promoting compliance with the I.R.C. by tax-exempt organizations. The EO function Examination Program's activities include analyzing the operational and financial activities of tax-exempt organizations and developing processes to identify areas of noncompliance, developing corrective strategies, and assisting other tax-exempt organization functions in implementing these strategies. The EO function Examination Program may assess payroll or other taxes and ask for payment of the delinquent tax.

However, if the tax-exempt organization does not make payment, the matter is referred to the IRS's Small Business/Self-Employed Division, which is responsible for collecting the delinquent debt. This division may use collection means such as Federal tax liens, levies, and seizures and may assess a Trust Fund Recovery Penalty against tax-exempt organization officials. In testimony, the former Commissioner, Tax Exempt and Government Entities Division, stated that "Compliance with payroll tax rules is not, in general, a requirement for continuing recognition as a tax-exempt organization. In exceptional circumstances, revocation of I.R.C. § 501(c)(3) exempt status for violation of payroll tax provisions, while an extraordinary measure, may be warranted where the violation of payroll tax law is so substantial that the organizations can be found to have a substantial nonexempt purpose."¹⁵ The former Commissioner, Tax Exempt and Government Entities Division, also stated that the IRS had not revoked the tax-exempt status of any organization solely because of payroll tax noncompliance.

Treasury Inspector General for Tax Administration (TIGTA) auditors received information from the Small Business/Self-Employed Division in Washington, D.C., and interviewed and received information from the Tax Exempt and Government Entities Division's EO function in Dallas, Texas; Ogden, Utah; and Washington, D.C., during the period January 2013 through January 2014. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to

¹⁵ Testimony of Steven T. Miller, Commissioner, Tax Exempt and Government Entities, IRS, Before the Oversight Subcommittee, House Ways and Means Committee (May 25, 2006).



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obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



Some Tax-Exempt Organizations Have Substantial Delinquent Payroll Taxes

Results of Review

Tax-Exempt Organizations Owe Millions in Federal Tax Debt

IRS records indicate that the majority of tax-exempt organizations pay their taxes. However, a small percentage of these organizations are still not paying their Federal taxes and are abusing¹⁶ the Federal tax system. We determined that more than 64,200¹⁷ (3.8 percent) tax-exempt organizations accumulated nearly \$875 million¹⁸ in Federal tax debt as of June 16, 2012.¹⁹ While some organizations owed minor amounts, approximately 1,200 tax-exempt organizations owed more than \$100,000 each. Taxes owed were associated with from one tax return to more than 40 payroll tax returns. For example, nine organizations each owed payroll taxes, including related penalties and interest, spanning 10 or more years that collectively total more than \$5.5 million.

We reviewed a judgmental sample²⁰ of 25 I.R.C. § 501(c)(3) tax-exempt organizations that appeared to be among the worst examples²¹ involving Federal tax debt. These organizations are not representative of the population of all tax-exempt organizations with delinquent taxes. Our

¹⁶ We considered activity to be abusive when a tax-exempt organization's actions (*e.g.*, repeated failure to forward payroll taxes to the IRS, which include amounts withheld from employees for Federal income, Social Security, and Medicare taxes that are required to be held "in trust" for the Federal Government but instead are retained by the tax-exempt organization for other purposes, including payment of salaries for executives) took advantage of the existing tax enforcement and administration system to avoid fulfilling Federal tax obligations and were deficient or improper when compared with behavior that a prudent person would consider reasonable.

¹⁷ This number is rounded for presentation purposes.

¹⁸ This amount only includes tax debts that tax-exempt organizations or courts have agreed to, which have been recorded on the IRS's computer system. This amount is also understated. See Appendix V for additional details. In addition, IRS officials stated that some information on Federal tax debt that TIGTA used for this analysis could be classified incorrectly by IRS systems. However, IRS management agreed that any inaccuracies would be immaterial for our findings and conclusions.

¹⁹ Approximately 9,200 of these tax-exempt organizations had a repayment plan with the IRS to pay back Federal tax debt of more than \$74 million. Some of the difference between the Federal tax debt reported by the GAO in June 2007 and the Federal tax debt owed as of June 16, 2012, could be due to the fact that a large number of tax-exempt organizations had their tax-exempt status automatically revoked (after the June 2007 GAO report was issued) for not filing tax-exempt organization returns (Forms 990) for three consecutive years. In addition, EO function management stated that the overall decrease in unpaid payroll tax could be attributed, in part, to the IRS's focus on identifying and reducing delinquent payroll tax through the use of the Combined Annual Wage Report program described later in this report.

²⁰ A judgmental sample is nonstatistical and cannot be used to project to the population.

²¹ These organizations are not representative of all delinquent organizations but appear to be among the worst examples of the more than 64,200 tax-exempt organizations with delinquent Federal taxes. Thus, the results from these 25 cases cannot be projected to the more than 64,200 tax-exempt organizations with delinquent Federal taxes.



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analysis determined that these organizations generally receive funds from Medicare, Medicaid, and government grants²² to finance operations; own substantial assets; continue to not remit payroll and other taxes, including penalties and interest; and are involved in potential criminal and abusive activity. The IRS tried to resolve the tax liabilities, and collection action had been taken on all 25 tax-exempt organizations and most officers of the organizations that we reviewed. Most of the organizations we reviewed were still recognized by the IRS as tax-exempt as of May 16, 2013. Federal statutes do not authorize the IRS to revoke tax-exempt status based on an organization's failure to pay payroll taxes or to require changes in the board of directors or the executives responsible for an organization's tax compliance problems.

The GAO had performed a similar analysis and reported in June 2007 that nearly 55,000 tax-exempt organizations owed almost \$1 billion in Federal tax debt as of September 30, 2006. The GAO selected 25 tax-exempt organizations and determined that, despite repeatedly abusing the Federal tax system, these entities continued to retain their tax-exempt status. This continued abuse costs the Federal Government millions of dollars in lost revenue.

Characteristics of tax-exempt organizations Federal tax debt

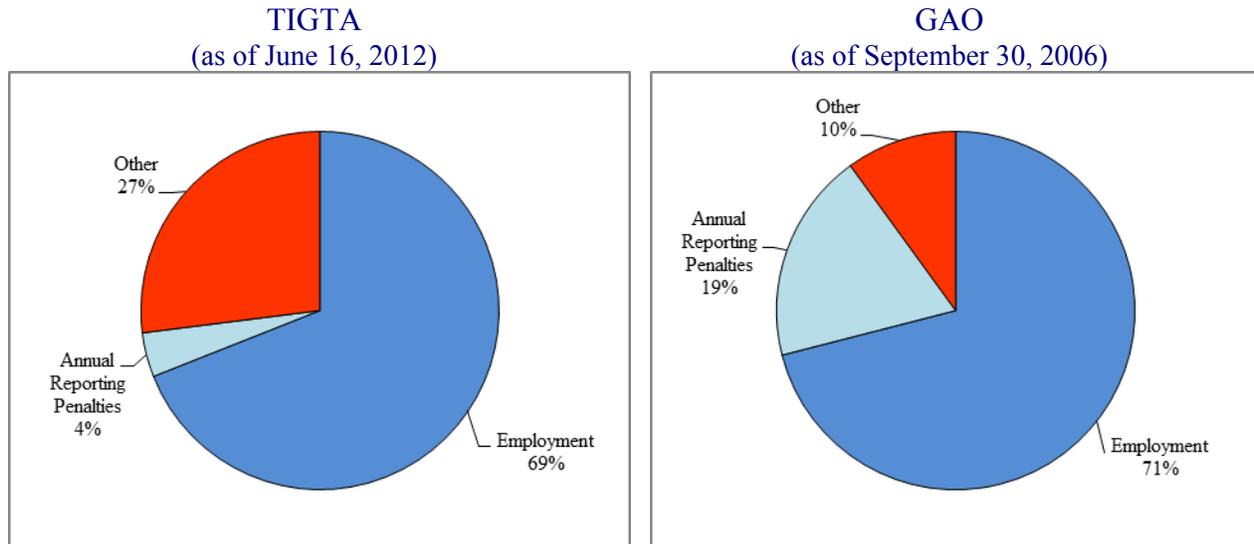
As shown in Figure 1, as of June 2012, about 69 percent of the nearly \$875 million in Federal tax debt is comprised of payroll taxes and related penalties and interest, as compared to 71 percent as of Fiscal Year 2006. About 4 percent, or more than \$39 million as of June 16, 2012, is related to annual reporting penalties. The IRS imposes reporting penalties on entities that fail to file annual returns, fail to file annual returns timely, or file inaccurate returns. The remaining 27 percent of the nearly \$875 million in Federal tax debt consisted of unrelated business income, excise, and other types of taxes. However, the nearly \$875 million in Federal tax debt is understated because the amount does not include unfiled or underreported payroll taxes, recently assessed and disputed debt, and unagreed debt. See Appendix V for additional information.

²² Information from Forms 990 generally does not differentiate State and Federal grants.



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Figure 1: Comparison of TIGTA and GAO Analysis of Federal Tax Debt of Tax-Exempt Organizations by Tax Type



Source: TIGTA analysis of IRS Taxpayer Service and Returns Processing report data.

Source: GAO, GAO-07-563 (June 2007).

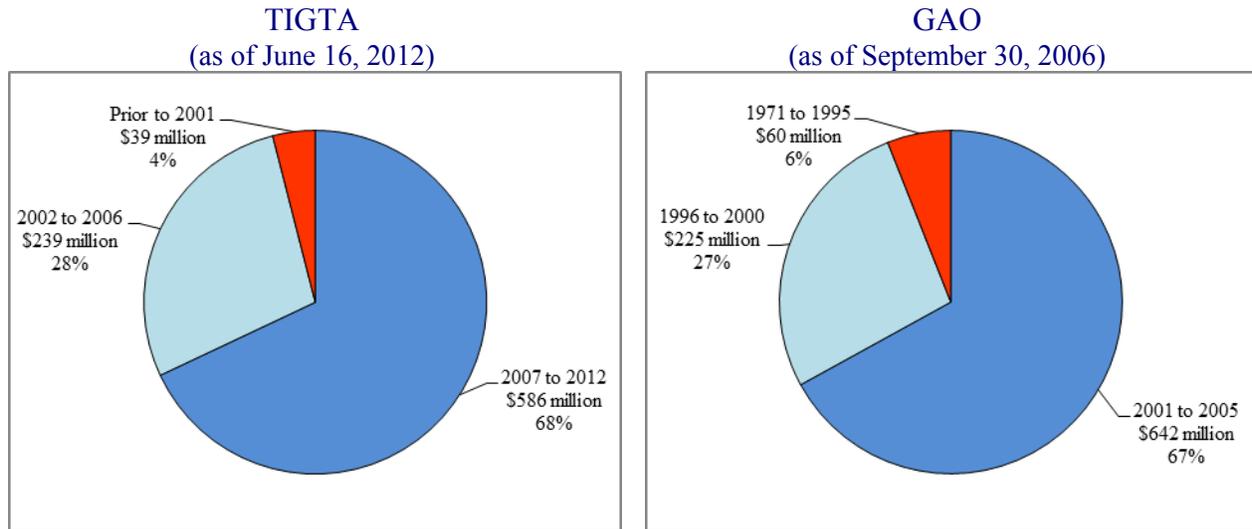
A significant amount of the Federal tax debt accumulated by tax-exempt organizations has been outstanding for several years. As reflected in Figure 2, while the majority of the nearly \$875 million in Federal tax debt as of June 16, 2012, originated from tax periods 2007 through 2012, more than a quarter of the debt originated in tax periods prior to 2007.²³ The age of outstanding tax-exempt organization Federal tax debt originating in the five-and-a-half-year period ending as of June 16, 2012, is comparable to that in the GAO's analysis as of the five-year period ending September 30, 2006.

²³ The \$875 million includes all agreed amounts, dating back to Tax Year 1981, that the IRS considers as being within the time period for collection.



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Figure 2: Comparison of TIGTA and GAO Analysis of Age of Federal Tax Debt Owed by Tax-Exempt Organizations



Source: TIGTA analysis of IRS Taxpayer Service and Returns Processing report data.

Source: GAO, GAO-07-563 (June 2007).

The age of delinquent debt is important because the likelihood of collecting all or a portion of the amount owed decreases over time.²⁴ This is, in part, because of the continued accrual of interest and penalties on the outstanding tax debt. Our analysis of IRS data found that a small number of tax-exempt organizations owed most of the nearly \$875 million in Federal tax debt:

- Over 1,200 tax-exempt organizations owed a total of nearly \$656 million (these organizations each owed more than \$100,000, with five each owing more than \$10 million).
- Nearly 7,000 tax-exempt organizations each owed from \$10,000 to \$100,000.
- More than 56,000 tax-exempt organizations each owed less than \$10,000.

²⁴ GAO, GAO-01-42, *Internal Revenue Service: Recommendations to Improve Financial and Operational Management* (Nov. 2000).



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- A total of seven officers underreported their wages on their tax returns by nearly \$350,000.
- A total of four officers also received Form W-2 wages from three other tax-exempt organizations. Collectively, tax-exempt organizations related to the four officers had Federal tax debt of nearly \$3 million.

The 25 tax-exempt organizations received government payments of more than \$148 million³⁰ for a three-year period. These organizations also had not paid more than \$25 million in taxes, mainly payroll taxes and related penalties and interest dating back as far as Tax Year 2001. For a single year, the 25 organizations had total revenue, including government grants, of almost \$167 million. In addition, the 25 organizations also owned more than \$97 million in assets. Instead of paying taxes, these organizations accumulated more and more Federal tax debt while continuing to operate with the benefits of an I.R.C. § 501 (c)(3) tax exemption.

In addition to identifying the abusive and potentially criminal activity related to the Federal tax system, we determined that the IRS took actions to enforce the I.R.C. as it related to these tax-exempt entities. During the collection process, revenue officers seek to get the entity in compliance with current deposit and payment requirements and request full payment of taxes owed.³¹ When taxpayers cannot fully pay the back taxes, the revenue officer may explore other collection alternatives such as installment agreements, or attaching liens and levies to property and assets, or assessing Trust Fund Recovery Penalties on officers of the entity.³²

Figure 3 shows that 32 Federal tax liens and 21 Federal tax levies were filed by the IRS in order to get the 25 tax-exempt organizations to pay their tax. These liens and levies were filed against 17 of 25 tax-exempt organizations and 14 of 52 officers of the tax-exempt organizations that we reviewed.³³ In addition, Trust Fund Recovery Penalties were filed against 22 of the 52 officers we reviewed, in the amount of almost \$2.4 million.

²⁹ Some did not file a Form 1040 in more than one year. A total of 21 Forms 1040 were not filed.

³⁰ We reviewed a three-year period for the judgmental sample of 25 tax-exempt organizations' Forms 990 between Tax Years 2006 and 2012 (but not always the same three years for each organization, and each organization did not receive government payments in all years).

³¹ Employers are generally required to pay payroll taxes periodically through the Federal Tax Deposit system.

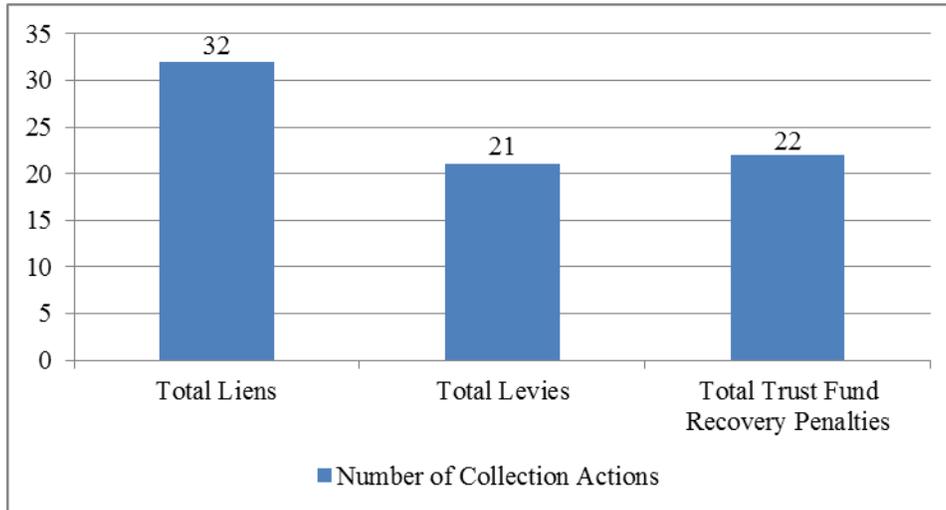
³² GAO, GAO-04-95, *Some DOD Contractors Abuse the Federal Tax System with Little Consequence* (Feb. 2004), reported that collections of Trust Fund Recovery Penalty assessments are generally minimal.

³³ Only one lien and levy is included per tax-exempt organization and officers' accounts. However, some accounts had multiple liens and levies.



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Figure 3: Total Number of Federal Liens and Levies Filed Against 25 Tax-Exempt Organizations and 52 Officers



Source: TIGTA analysis of IRS Integrated Data Retrieval System data.

While attempting to collect the delinquent tax, the IRS was sometimes faced with the dilemma of seizing property or serving levy actions for the organization’s funds intended to support the tax-exempt organizations that, if seized, could potentially result in closing the entity and its services to the community. The seizure of property was discussed, but no seizures occurred for the 25 tax-exempt organizations we reviewed. In addition, we observed that tax-exempt organization officials sometimes individually filed for bankruptcy and requested and later withdrew or defaulted on installment agreements.

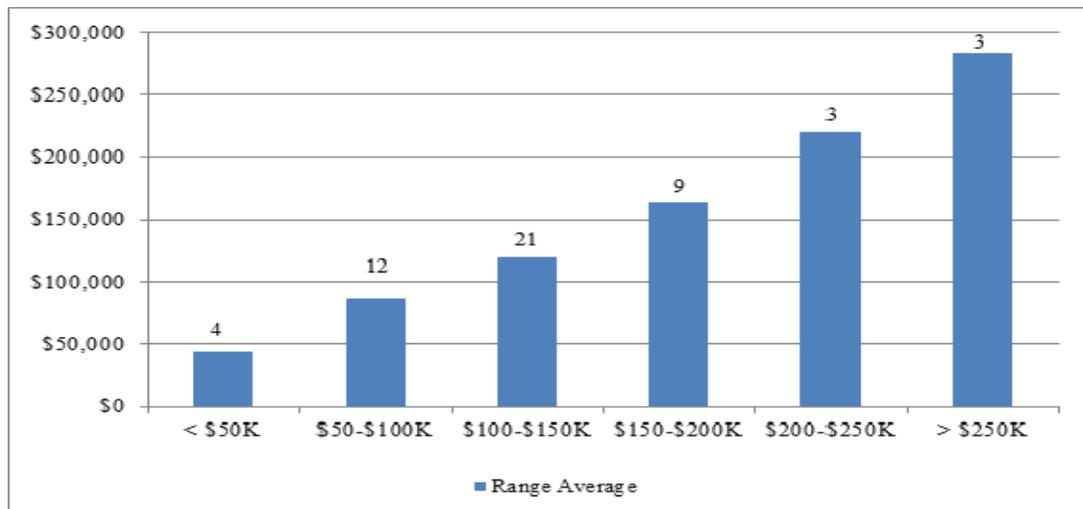
Collection actions on 10 of the 25 tax-exempt organizations were closed as currently not collectible, and most of the entities were still recognized by the IRS as tax-exempt organizations as of May 16, 2013. In addition, the IRS assessed almost \$2.4 million in Trust Fund Recovery Penalties on 22 officers of these tax-exempt organizations. At the time of our audit, fewer than five officers had made payments for a little more than \$15,000 (less than 1 percent of the amount owed), and debts were closed as currently not collectible.

In addition, Figure 4 shows that the 25 tax-exempt organizations paid 52 officers’ salaries ranging from \$35,000 to more than \$250,000 annually.



Some Tax-Exempt Organizations Have Substantial Delinquent Payroll Taxes

**Figure 4: Analysis of Form W-2 Wages Received by Tax-Exempt Organization Officers³⁴
Tax Years 2009 Through 2011**



Source: TIGTA analysis of Forms W-2 for Tax Years 2009 through 2011. Salaries in Figure 4 are an annual average for this time period (not all officers received Form W-2 from the tax-exempt organization for all three years; only the years worked were included in the average).

When comparing the 22 Trust Fund Recovery Penalties in Figure 3 to the salary analysis in Figure 4, we found that approximately half the penalty assessments were made during Tax Years 2009 through 2011 and the remaining half were evenly split before and after that time period.

We shared the results of our review of the 25 tax-exempt organizations³⁵ with EO function management to determine if access to the information we gathered from review of publicly available information and collection activities would prove useful during examinations of the tax-exempt organizations. EO function management stated that they do not receive information from Small Business/Self-Employed Division employees responsible for collecting unpaid taxes. They also stated that having access to publicly available information similar to what we identified could be useful for opening examinations. In addition, they provided the following information about the 25 tax-exempt organizations and 52 officers we reviewed:

- EO function management received seven referrals and conducted examinations on three of the 25 tax-exempt organizations for issues such as political campaign intervention,³⁶

³⁴ The bars in Figure 4 represent the average of all salaries within that range, and the number above each bar represents the number of officers whose wages are within that range.

³⁵ We located collection histories for most of the tax-exempt organizations we reviewed.

³⁶ I.R.C. § 501(c)(3) organizations are prohibited from participating in any political campaign on behalf of, or in opposition to, any candidate to elective office.



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substantial legislative activities, excessive personal benefits, inappropriate loans, and other fraudulent issues.

In addition to the three examinations above, the EO function also conducted examinations on four of the 25 tax-exempt organizations after identifying indications of potential issues such as excessive executive compensation, questions on governance,³⁷ or inconsistent reporting on Forms 940, Forms 941, and Forms W-2. In cases of excess compensation, the IRS generally tries to impose a tax on the individual who received the excess benefits³⁸ rather than revoke the tax-exempt status of the organization.

- Officers for three additional tax-exempt organizations in our judgmental sample are being considered for Trust Fund Recovery Penalty assessments.
- Four of 25 organizations were in jeopardy of having their tax exemption automatically revoked for not having filed a Form 990 for three years. However, if a Form 990 is filed within the three-year period, the organization's tax-exempt status will not be automatically revoked.

Although the I.R.C. provides exemptions from paying income taxes to organizations that meet the exemption requirements, the I.R.C. does not provide the IRS with the means to revoke the tax-exempt status of organizations that do not pay payroll taxes and other related penalties and interest or to require changes in the board of directors or the executives responsible for an organization's tax compliance problems. Our review of the I.R.C. identified the following circumstances in which a tax-exempt entity may have its tax-exempt status revoked.

- The Pension Protection Act of 2006³⁹ requires most tax-exempt organizations to file an annual information return or submit an annual electronic notice with the IRS. Tax-exempt organizations required to file an annual return or submit an annual electronic notice are subject to automatic revocation for failure to file for three consecutive years.
- Organizations recognized as tax exempt under I.R.C. § 501(c)(3) that act in a manner inconsistent with the I.R.C. may no longer qualify to be tax exempt. Examples include ceasing to engage in the activities for which the tax-exempt status was approved, having substantial unrelated business activities (trade or business activities unrelated to its tax-exempt purpose), or private benefit/inurement. In addition, organizations exempt under I.R.C. § 501(c)(3) are prohibited from making political contributions or

³⁷ Governance relates to who governs the organization, policies and practices the organization has in place, and disclosure and transparency of certain information.

³⁸ In early Calendar Year 2007, the IRS reported the results of a study done on tax-exempt organizations' executive compensation. A result of this report was the proposed assessment of excise taxes totaling \$21 million against 40 executives of nonprofit organizations whom it had determined had been paid excessively.

³⁹ Pub. L. No. 109-280.



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participating in political campaigns and from influencing legislation to a substantial degree (lobbying).

Providing an exemption from paying income tax is recognition by the Federal Government of the importance of services provided by charitable organizations. In addition, governments also support tax-exempt organizations by providing revenue to fund operations.

The I.R.C. provides the IRS with the authority to approve and monitor tax-exempt organizations and also stipulates certain circumstances under which the organization's tax-exempt status may be automatically revoked or when organizations may no longer qualify to be tax exempt. Although tax-exempt organizations are generally responsible for payment of payroll and certain other taxes, some are not paying their required taxes (including amounts withheld from their employees) and are abusing the Federal tax system.

IRS officials informed us that revocation is an action of last resort, arrived at after evaluation of many factors and after imposing intermediate sanctions⁴⁰ to try and correct the problem. The I.R.C. does not authorize the IRS to revoke tax-exempt status based on an organization's failure to pay payroll taxes or allow the IRS to require changes to the board of directors or the executives responsible for an organization's tax compliance problems. Therefore, tax-exempt organizations can continue to avoid paying these taxes.

Recommendations

The Director, EO, should:

Recommendation 1: Coordinate with Small Business/Self-Employed Division management to determine what information or systems are available from collection cases that would be useful in identifying tax-exempt organizations potentially abusing the tax system.

Management's Response: The IRS disagreed with this recommendation. According to the IRS, the Collection functions generally do not gather information useful in identifying tax-exempt organizations potentially operated for the benefit of board members, trustees, officers, or key employees. Therefore, the EO function does not plan to coordinate with the IRS's Collection functions for indications of nonexempt purpose and/or private inurement. However, the IRS stated that the EO function will continue to apply specific criteria useful in identifying tax-exempt organizations being operated potentially for the benefit of board members, trustees, officers, or key employees.

Office of Audit Comment: IRS management did not agree with this recommendation because they believe that Collection function information relating to tax noncompliance for tax-exempt organizations would not be useful for the specific purpose of determining

⁴⁰ I.R.C. § 4958 provides for levying an excess benefit tax on individuals who have unduly enriched themselves at the expense of a tax-exempt organization.



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whether they were being operated for the benefit of board members, trustees, officers, or key employees. TIGTA did not recommend that the IRS use Collection function information to investigate the specific issue of whether tax-exempt organizations are being operated for the benefit of board members, trustees, officers, or key employees. For most of the 25 cases we reviewed, which were among the most egregious cases of tax noncompliance for tax-exempt organizations, the EO function was not aware of these organizations' tax problems. In all 25 cases, the EO function had granted these organizations I.R.C. § 501(c)(3) status. At the same time, these organizations repeatedly failed to remit payroll taxes. In addition, some of these organizations were paid millions of dollars of Medicare and Medicaid funds and thus were benefitting from the very fund—the Medicare trust fund—supported by the taxes they failed to remit.

To identify tax-exempt organizations with substantial tax problems, we used the IRS's own data. Thus, the EO function could perform similar analyses using IRS data. We continue to believe that the EO function should use the data available that would be useful in identifying tax-exempt organizations potentially abusing the tax system.

Recommendation 2: Periodically complete analyses to identify tax-exempt organizations with significant unpaid payroll and other Federal taxes and that receive funding from government grants and pay large salaries to executives and officers. Evaluate these organizations to determine if there are any issues that may warrant examinations.

Management's Response: The IRS disagreed with this recommendation. According to the IRS, the EO function already uses and will continue to use data analytics on the filings of information and taxable returns by tax-exempt organizations in determining indications of nonexempt purpose and/or private inurement. The IRS stated that the EO function will continue to apply specific criteria useful in identifying tax-exempt organizations being operated potentially for the benefit of board members, trustees, officers, or key employees.

Office of Audit Comment: As noted above, we did not recommend that the IRS complete analyses to identify tax-exempt organizations that are being operated for the benefit of board members, trustees, officers, or key employees. Instead, we believe the IRS should use its own data to identify and be aware of tax-exempt organizations with substantial tax noncompliance. This information should be used to monitor these organizations and determine whether tax-exempt issues may need to be examined.

Legislative Recommendation

Recommendation 3: Work with the Department of the Treasury to evaluate whether a legislative proposal is warranted to strengthen the IRS's ability to enforce payroll tax noncompliance by tax-exempt organizations.



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Management's Response: The IRS agreed with this recommendation. The IRS responded that, as the report recognizes, the Secretary of the Treasury has delegated the formulation of tax policy, including legislative initiatives, to the Assistant Secretary, Tax Policy. See *Treasury Order 111-01 (Mar. 16, 1981)*; *Treasury Directive 27-10 (Oct. 15, 1990)*. The IRS stated that, because speculation on potential policy implications is beyond the scope of tax administration in this report, it will apprise the Office of Tax Policy of the recommendation.

Actions Were Taken to Identify Tax-Exempt Organizations With Federal Tax Debt

In response to the 2007 GAO report, IRS Tax Exempt and Government Entities Division management initiated two projects to enhance EO function tax compliance efforts. First, EO function management worked with Small Business/Self-Employed Division management on the Combined Annual Wage Report program to identify tax-exempt organizations not meeting their payroll tax and filing obligations. Second, the EO function developed a Risk Modeling Program to identify tax-exempt organizations with a high risk of noncompliance.

The Combined Annual Wage Report program compares wage and salary data reported to the Social Security Administration by employers to payroll tax information reported to the IRS by employers on Form 941 to identify and resolve any discrepancies. During the first quarter of each calendar year, the IRS receives prior calendar year Form W-2 records from the Social Security Administration. The Forms W-2 are sorted and summarized by payer Employer Identification Number and matched to employers' Form 941 tax records filed with the IRS. The EO function then initiates examinations or compliance checks on entities that filed Form W-2 information with the Social Security Administration but have not filed the corresponding Forms 941 with the IRS.

From Fiscal Years 2007 through 2012, the EO function Examination Program conducted the following Combined Annual Wage Report projects:

- The **Credit Balance project** was based on organizations that paid the tax due without filing the appropriate tax return with the IRS.
- The **Federal Unemployment Tax Act project** was a compliance check to secure delinquent tax forms and to ensure that the tax-exempt organizations are in full compliance with all of their tax filing requirements.
- The **Employment Tax project** focused on tax-exempt organizations whose reported amounts on Forms W-2 to the Social Security Administration and on Forms 941 or Forms 944 to the IRS showed a difference of at least \$40,000.

EO function management stated that the Combined Annual Wage Report program has been successful. The Combined Annual Wage Report projects resulted in the EO function closing



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examinations of almost 9,000 returns and assessing tax and penalties of more than \$57 million. However, it is unknown by EO function management how much of the \$57 million was collected because the projects did not focus on collecting the delinquent tax, which is a responsibility of the Small Business/Self-Employed Division.

For the Risk Modeling Program, the Risk Model was designed to electronically identify the tax returns of noncompliant organizations, facilitate the development of EO function noncompliance risk assessment strategies, and reduce the taxpayer burden associated with the examination of compliant organizations. The program focused on several areas including overall noncompliance, unrelated business income, payroll tax, and (in certain instances) gaming. While successful in some areas, the program was not as successful at predicting noncompliance for payroll tax issues and needed additional testing prior to implementation for widespread use. The program was discontinued in Fiscal Year 2010 due to revisions to the Forms 990.

EO function management plans to continue working the Combined Annual Wage Report projects, and their Compliance Strategies Critical Initiatives group, which identifies areas of noncompliance and develops strategies to improve compliance through examinations, is working to develop a program similar to the Risk Modeling Program. However, there is no timeline for when the program will be completed.



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Appendix I

Detailed Objectives, Scope, and Methodology

Our overall objectives were to determine if, and to what extent, tax-exempt organizations have known Federal tax debt and to identify actions the EO function has taken to address tax-exempt organizations' noncompliance. To accomplish our objectives, we:

- I. Determined if, and to what extent, tax-exempt organizations have known Federal tax debt.
 - A. Obtained the EO Master File¹ population of tax-exempt entities as of December 2012 from the TIGTA Data Center Warehouse and eliminated those without a current tax exemption. We accomplished this by using codes on the EO Master File indicating the most recent exemption status of an organization. For consistency, we used codes similar to those used in the June 2007 GAO report.²
 - B. Matched the current tax-exempt organizations identified from Step I.A. to IRS Taxpayer Service and Returns Processing Category data to identify tax-exempt organizations that have Federal tax debt as of June 16, 2012, the latest date for which data were available.
 - C. Determined the IRS EO Master File and Taxpayer Service and Returns Processing Category data were sufficiently reliable for our purpose through observation of data fields and through testing a judgmental sample³ of cases. Testing was completed to determine that dollar fields contained monetary amounts, date fields contain dates, *etc.*, and that any material blank fields were explainable. In addition, data from a judgmental sample of 25 tax-exempt organizations identified from the Taxpayer Service and Returns Processing Category data were compared to data from the Integrated Data Retrieval System and Forms 990.⁴ See Step II.A.
 - D. Compared the results of the Taxpayer Service and Returns Processing Category analysis to results from the June 2007 GAO report.

¹ See Appendix VII for a glossary of terms.

² GAO, GAO-07-563, *Thousands of Organizations Exempt from Federal Income Tax Owe Nearly \$1 Billion in Payroll and Other Taxes* (June 2007).

³ A judgmental sample is nonstatistical and cannot be used to project to the population.

⁴ See Appendix VI for a list of tax and wage forms cited in this report. Tax-exempt organizations are required to file IRS Form 990, Form 990-EZ, or Form 990-N. Churches and certain other tax-exempt organizations with less than \$50,000 in annual revenues are not required to file.



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- II. Reviewed a judgmental sample of executives and officers of tax-exempt organizations with large unpaid payroll taxes to identify potential abusive and criminal activity.
- A. Chose a judgmental sample of 25 current tax-exempt organizations from the population of 64,200 tax-exempt organizations from Taxpayer Service and Returns Processing Category data with Federal tax debt. Selection criteria included tax-exempt organizations that were delinquent for five or more tax periods in paying their payroll or other tax and tax-exempt organizations that accepted funding from Medicare, Medicaid, and government grants. Not paying tax, especially payroll tax that is withheld from employees to be submitted to the Federal Government, shows a potential willful intent of tax avoidance or abuse. Forms 990 were reviewed to identify the executives and officers of the tax-exempt organizations and Medicare, Medicaid, and government grants. We also chose a judgmental sample of 52 of 217 executives and officers from the 25 tax-exempt organizations. Selection criteria included executives and officers receiving large salaries.
- We selected a judgmental sample of 25 tax-exempt organizations and 52 executives and officers because we wanted to focus on those organizations that generally had a history of not paying payroll or other tax, paid large salaries to executives and officers, and received Medicare, Medicaid, and government grants to fund operations. We also chose a judgmental sample because we did not plan on projecting the results to the entire population of tax-exempt organizations or the executives and officers.
- B. Reviewed Integrated Collection System case histories and Integrated Data Retrieval System data to identify installment agreements as well as liens, levies, and seizures against the 25 tax-exempt organizations and 52 executives and officers.
- C. Analyzed Form W-2 data to verify income for the judgmental sample of 52 executives and officers.
- D. Reviewed Integrated Data Retrieval System data to identify Trust Fund Recovery Penalties assessed on accounts of the judgmental sample of 52 executives and officers.
- III. Determined what actions the EO function took in response to the June 2007 GAO report.
- A. Determined actions taken by the EO function to identify and resolve agreed unpaid balances for tax-exempt organizations and to identify and resolve abusive actions by officers and executives of tax-exempt organizations with agreed unpaid balances.
- B. Determined if feedback is received from the Small Business/Self-Employed Division on collection actions taken on tax-exempt organizations and their officers and executives.



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- C. Determined how the EO function uses the Combined Annual Wage Report analysis to identify and resolve discrepancies between payroll data reported to the Social Security Administration and data reported to the IRS.
- D. Determined how the EO function developed and used a modeling program to identify tax-exempt organizations with a high risk of payroll tax noncompliance.
- E. Determined actions taken by the EO function for the judgmental sample of tax-exempt organizations with unpaid payroll taxes from Step II.A.

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 objectives: controls put into place in response to a June 2007 GAO report (identification of unpaid tax through use of the Combined Annual Wage Report and the Risk Modeling programs) as well as the exchange of information between the Small Business/Self-Employed Division and the EO function. We evaluated these controls by interviewing IRS officials, reviewing applicable documentation, and reviewing tax data regarding tax-exempt organizations with significant Federal tax debt.



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Appendix II

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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Assistant Secretary of the Treasury for Tax Policy
Deputy Commissioner for Services and Enforcement SE
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
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaison: Director, Communications and Liaison, Tax Exempt and Government Entities
Division SE:T:CL



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Appendix IV

*Types of Internal Revenue Code
Section 501(c) Tax-Exempt Organizations*

Section 501(c) of the I.R.C. lists several types of organizations that qualify for exemption from Federal income taxes.

I.R.C. Section	Donations Deductible to Donors	Summary
501(c)(1)	Yes, if made for exclusively public purposes	Corporations Organized Under Act of Congress (including Federal Credit Unions)
501(c)(2)	No	Title Holding Corporation for Exempt Organization
501(c)(3)	Yes, generally	Religious, Educational, Charitable, Scientific, Literary, Testing for Public Safety, to Foster National or International Amateur Sports Competition, or Prevention of Cruelty to Children or Animals Organizations
501(c)(4)	No, generally	Civic Leagues, Social Welfare Organizations, and Local Associations of Employees
501(c)(5)	No	Labor, Agricultural, and Horticultural Organizations
501(c)(6)	No	Business Leagues, Chambers of Commerce, Real Estate Boards, <i>etc.</i>
501(c)(7)	No	Social and Recreational Clubs
501(c)(8)	Yes, if for certain I.R.C. § 501(c)(3) purposes	Fraternal Beneficiary Societies and Associations
501(c)(9)	No	Voluntary Employees' Beneficiary Associations
501(c)(10)	Yes, if for certain I.R.C. § 501(c)(3) purposes	Domestic Fraternal Societies and Associations
501(c)(11)	No	Teachers' Retirement Fund Associations



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I.R.C. Section	Donations Deductible to Donors	Summary
501(c)(12)	No	Benevolent Life Insurance Associations, Mutual Ditch or Irrigation Companies, and Mutual or Cooperative Telephone Companies
501(c)(13)	Yes, generally	Cemetery Companies
501(c)(14)	No	State-Chartered Credit Unions, Mutual Reserve Funds
501(c)(15)	No	Mutual Insurance Companies or Associations
501(c)(16)	No	Cooperative Organizations to Finance Crop Operations
501(c)(17)	No	Supplemental Unemployment Benefit Trusts
501(c)(18)	No	Employee-Funded Pension Trust (created before June 25, 1959)
501(c)(19)	No, generally	Post or Organization of Past or Present Members of the Armed Forces
501(c)(21)	No	Black Lung Benefit Trusts
501(c)(22)	No	Withdrawal Liability Payment Fund
501(c)(23)	No, generally	Veterans Organization (created before 1880)
501(c)(25)	No	Title Holding Corporations or Trusts With Multiple Parents
501(c)(26)	No	State-Sponsored Organizations Providing Health Coverage for High-Risk Individuals
501(c)(27)	No	State-Sponsored Workers' Compensation Reinsurance Organization
501(c)(28)	No	National Railroad Retirement Investment Trust
501(c)(29)	No	Consumer Operated and Oriented Plan Health Insurance Insurers

Source: IRS Publication 557, *Tax-Exempt Status for Your Organization*.



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Appendix V

*The Amount of Federal Tax Debt Is
Understated for Tax-Exempt Organizations*

We determined that nearly \$875 million in Federal tax debt was owed by tax-exempt organizations as of June 16, 2012. However, the full extent of the debt is understated for the following reasons.

- This amount does not include certain amounts due to the IRS from tax-exempt organizations that should have but did not file payroll taxes (nonfilers) or underreported payroll tax liability (underreporters).
- This amount does not include some recently assessed tax debts that appear as unpaid taxes and may involve matters that are routinely resolved between the tax-exempt organization and the IRS, with the taxes paid, abated, or both within a short period of time. For example, in our analysis we did not include unpaid payroll tax unless the delinquency was more than a year old.
- This amount does not include tax debt the IRS identified as not agreed to by the tax-exempt organization. For example, we eliminated from our analysis all tax debt that is being appealed or disputed in tax court.



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Appendix VI

Tax and Wage Forms Referred to in This Report

Term	Definition
Form 940	Employer's Annual Federal Unemployment (FUTA) Tax Return
Form 941	Quarterly Federal Tax Return
Form 944	Employer's Annual Federal Tax Return
Form 990	Return of Organization Exempt From Income Tax
Form 990-EZ	Short Form Return of Organization Exempt From Income Tax
Form 990-N	e-Postcard
Form 1040	U.S. Individual Income Tax Return
Form W-2	Wage and Tax Statement



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Appendix VII

Glossary of Terms

Term	Definition
Abatement	I.R.C. § 6404 defines abatements as reductions in the amount of taxes owed. They can occur for a variety of reasons, such as to correct errors made by the IRS or taxpayers or to provide relief from interest and penalties.
Business Master File	The IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.
Compliance Checks	Compliance checks are reviews to determine if IRS customers adhere to recordkeeping and information reporting requirements.
Data Center Warehouse	A centralized storage facility that provides security and administration of data files. It provides data and data access services enabling auditors to access historical IRS data files.
Employer Identification Number	A unique nine-digit number used to identify a taxpayer's business account.
Examinations	Examinations are legal proceedings, require participation by IRS customers, and include a review of books and records to determine compliance with the I.R.C.
Exempt Organizations Master File	The IRS's computer system for all organizations that have had an application for tax exemption processed. The system is also updated by returns received, examination results, <i>etc.</i>
Government Grant	A government grant is an award of financial assistance from a government agency to carry out an agreed-upon public purpose.
Fiscal Year	Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.
Individual Master File	The IRS database that maintains transactions or records of individual tax accounts.
Integrated Collection System	An information management system designed to improve revenue collections by providing revenue officers with access to the most current taxpayer information while in the field using laptop computers for quicker case resolution and improved customer service.



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Term	Definition
Integrated Data Retrieval System	The IRS computer system capable of retrieving and updating stored taxpayer account information.
Levy	A method used by the IRS to collect outstanding taxes from sources such as bank accounts and wages.
Lien	A legal right to or interest in property as security for outstanding taxes.
Private Benefit/ Inurement	A section 501(c)(3) organization must not be organized or operated for the benefit of private interests, such as the creator or the creator's family, shareholders of the organization, other designated individuals, or persons controlled directly or indirectly by such private interests. No part of the net earnings of a section 501(c)(3) organization may inure to the benefit of any private shareholder or individual. A private shareholder or individual is a person having a personal and private interest in the activities of the organization.
Revenue Officer	Revenue officers collect taxes due and are critical positions for achieving the IRS's mission.
Seizure	The taking of a taxpayer's property to satisfy his or her outstanding tax liability.
Tax Gap	The gross Tax Gap is the total estimated tax liability that is not paid voluntarily and timely. It is the difference between what taxpayers owe (all taxes legally owed, including underreported and nonfiler amounts) and what the IRS collects through timely voluntary compliance. The net Tax Gap is calculated by subtracting the amount the IRS recovers through enforcement actions and late payments.
Tax Period	A tax period varies by tax type. For example, the tax period for payroll and excise taxes is generally one quarter of a year. The taxpayer is required to file quarterly returns with the IRS for these types of taxes, although payment of the taxes occurs throughout the quarter.
Tax Year	A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.
Taxpayer Service and Returns Processing Category File	A part of the Accounts Receivable Dollar Inventory. These files are generated on a quarterly basis from both the Individual Master File and Business Master File.
Trust Fund Taxes	The IRS defines a trust fund tax as money withheld from an employee's wages by an employer and held in trust until paid to the U.S. Department of the Treasury.



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Appendix VIII

Management's Response to the Draft Report

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

COMMISSIONER
TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

April 28, 2014

MEMORANDUM FOR MICHAEL E. MCKENNEY
ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: *for* Sunita B. Lough /s/ Donna Hansberry

SUBJECT: Draft Audit Report - Some Tax-Exempt Organizations Have Substantial
Delinquent Payroll Taxes (Audit #2013-10-026)

Thank you for the opportunity to review and respond to the subject audit report. We concur with your findings that the majority of tax-exempt organizations pay their Federal payroll taxes and only a small percentage of the exempt organizations are not meeting their filing and payment obligations.

We would like to note that the report paints an incomplete picture about IRS enforcement efforts on employment tax, particularly in regard to these 25 tax-exempt organizations. Our efforts reflect that our tax administration and enforcement efforts are working. For example, the IRS opened collection cases on all 25 organizations. In all, 17 of these cases have been closed and our work continues on the eight remaining groups. Additionally, the report discusses a "judgmental sample" of 52 officials from the 25 organizations. Of these 52, the IRS has: imposed current assessments against 20 for the applicable payroll tax penalty; collected the penalty in full from 4; determined that 22 were not liable for the penalty; continued open investigations of 4; and proceeded with appeals of ***1*** who have chosen to exercise those rights.

It's also important to note that reductions in the IRS budget have stretched enforcement resources across the agency. In Fiscal 2014, the IRS budget had been reduced by nearly \$850 million less compared to Fiscal 2010. During the same time period, the IRS has seen the number of key enforcement personnel drop by 3,000 positions.

As your report recognizes, current law does not authorize the IRS to revoke an organization's tax-exempt status based on the organization's failure to pay payroll taxes. The employment tax statute applies to all employers regardless of their income tax status,



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whether as corporations that pay income tax, partnerships whose income tax liabilities pass through to the partners, or public or private entities exempt from income tax. *See* IRC §§ 3111, *et seq.* As your report recognizes, since the IRS Restructuring & Reform Act of 1998, Pub. L. No. 105-206, the IRS has been organized functionally.

Consequently, the Small Business/Self-Employed Operating Division (SB/SE) collects the employment tax even if the employer is an entity exempt from income tax. *See* Int. Rev. Man. 5.7 (Nov. 29, 2012). Where the employer is a taxable entity, payroll tax underpayment does not preclude the application of other tax provisions, such as accelerated depreciation or credit for research activities, although those may be substantial amounts officially classified as tax expenditures. *See e.g.* Budget of U.S. Gov't FY '14, Analytical Perspectives, Table 16-3 (reflecting tax expenditures of \$17.85 Billion for accelerated depreciation of machinery and equipment). Similarly, payroll tax underpayment does not preclude the application of tax-exemption provisions.

You selected 25 tax-exempt organizations that "appeared to be among the worst examples involving Federal tax debt" for your audit sample. You found that these 25 organizations owed approximately \$25 million in unpaid payroll tax, penalties, and interest as of June 2012. All of these cases were selected for inclusion in the Federal Payment Levy Program (FPLP) for automatic/continuous levy against Federal Payments. The FPLP did collect money on 6 cases. (Some of the grants that these organizations received were state grants that are not subject to the FPLP.) Additionally, collection cases were opened on all 25 organizations; 17 cases are fully paid, paid with an accepted offer in compromise, in bankruptcy, or currently not collectible. Of the 8 cases remaining open as of February 2014, three of these organizations have entered into installment agreements or have installment agreement applications pending. Further, the total unpaid assessments, not including accrued penalties and interest, owed by these 8 organizations is approximately \$11.5 million.

SB/SE did not seize property from any of the 25 organizations, but as you acknowledge in your report, SB/SE did consider seizures in appropriate cases. We appreciate your recognition that, when considering the seizure of property, SB/SE faces the dilemma of seizing property or serving levy actions for the organization's funds intended to support the tax-exempt organizations that, if seized, could potentially result in closing the entity and its services to the community.

You also reviewed a judgmental sample of 52 responsible officials from these 25 tax-exempt organizations, but the report does not specify any selection criteria for this sample. The 25 cases are not representative of any lapse in tax administration. You determined that "22 officers were involved in abusive activity." SB/SE reviewed the cases of these 52 responsible officials. There are current assessments against 20 of these officials for the trust fund recovery penalty (TFRP). Of the remaining 32 officials, SB/SE determined that 22 were not responsible for the TFRP, 4 have fully paid the TFRP, *****1***** have appealed our determination that they are liable for the TFRP, and 4 have open investigations to determine whether they are responsible officials under the law. More



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3

than 70 percent of the 52 responsible officials are current on their individual income tax filing obligations, and when you readjust the data to reflect those that filed joint returns with their spouses, the reported salaries of the responsible officials who did not file is less than \$1.1 million. SB/SE has open tax delinquency inquiries on the officials who are not current on their individual income tax filings.

Your report makes the illogical conclusion that "tax-exempt organizations can continue to avoid paying these [payroll] taxes" because current law "does not authorize the IRS to revoke tax-exempt status based on an organization's failure to pay payroll taxes". As stated above, payroll tax collection proceeds regardless of income tax status. Even if exempt status were revoked, payroll tax law would apply separately. The Exempt Organization function does not receive payroll tax information from SB/SE where that would be irrelevant to examinations for potential private inurement.

The proscription on private inurement means that a "charity is not to siphon its earnings to an owner or manager." *United Cancer Council v. Comm'r*, 165 F.3d 1173 (7th Cir. 1999). Here, the organizations may have been the victims of embezzlement rather than entities that deliberately siphoned their earnings to managers. Your report includes no facts to show that any of the exempt organizations collaborated or conspired with the responsible officials. Accordingly, TE/GE will continue to pursue relevant selection criteria for examinations. See IRM 4.76.3.11, *Inurement, Private Benefit and Excess Benefit Transactions* (Apr. 1, 2003).

Our response to your specific recommendations is detailed in the attachment. If you have any questions, please contact me, or a member of your staff may contact Mary Epps, Acting Director, Exempt Organizations Examinations at (404) 338-8214.

Attachment



Some Tax-Exempt Organizations Have Substantial Delinquent Payroll Taxes

Attachment

Draft Audit Report - Some Tax-Exempt Organizations Have Substantial Delinquent Payroll Taxes

Recommendation #1

Coordinate with Small Business/Self-Employed Division management to determine what information or systems are available from collection cases that would be useful in identifying tax-exempt organizations potentially abusing the tax system.

Corrective Action

The IRS's Collection functions generally do not gather information useful in identifying tax-exempt organizations potentially operated for the benefit of board members, trustees, officers, or key employees. Therefore, we do not plan to coordinate with the IRS's Collection functions for indications of non-exempt purpose and/or private inurement. However, Exempt Organizations will continue to apply specific criteria useful in identifying tax-exempt organizations being operated potentially for the benefit of board members, trustees, officers, or key employees.

Implementation Date

N/A

Responsible Official

N/A

Recommendation #2

Periodically complete analyses to identify tax-exempt organizations with significant unpaid payroll and other Federal taxes and that receive funding from government grants, and pay large salaries to executives and officers. Evaluate these organizations to determine if there are any issues that may warrant examinations.

Corrective Action

Exempt Organizations already uses and will continue to use data analytics on the filings of information and taxable returns by tax-exempt organizations in determining indications of non-exempt purpose and/or private inurement. Exempt Organizations will continue to apply specific criteria useful in identifying tax-exempt organizations being operated potentially for the benefit of board members, trustees, officers, or key employees.



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Implementation Date

N/A

Responsible Official

N/A

Legislative Recommendation #3

Work with the Department of the Treasury to evaluate whether a legislative proposal is warranted to strengthen IRS's ability to enforce payroll tax non-compliance by tax-exempt organizations.

Corrective Action

As the report recognizes, the Secretary of the Treasury has delegated the formulation of tax policy, including legislative initiatives, to the Assistant Secretary, Tax Policy. See Treasury Order 111-01 (Mar. 16, 1981); Treasury Directive 27-10 (Oct. 15, 1990). Because speculation on potential policy implications is beyond the scope of tax administration in this report, we will apprise the Office of Tax Policy of the recommendation.

Implementation Date

September 30, 2014

Responsible Official

Director, Exempt Organizations



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Appendix IX

Office of Audit Comments on Management's Response

In response to our draft report, the Commissioner, Tax Exempt and Government Entities Division, included some general comments and assertions that we believe warrant additional comment. We have included portions of management's response and our related comments below.

Management Statement: *Additionally, collection cases were opened on all 25 organizations, 17 cases are fully paid, paid with an accepted offer in compromise, in bankruptcy, or currently not collectible. Of the eight cases remaining open as of February 2014, three of these organizations have entered into installment agreements or have installment agreement applications pending. Further, the total unpaid assessments, not including accrued penalties and interest, owed by these 8 organizations is approximately \$11.5 million.*

Office of Audit Comment: Most of the 25 organizations have not fully paid their Federal tax debt subsequent to the end of our audit fieldwork. The amount of Federal tax debt owed by the organizations, including penalties and interest, has grown to more than \$30 million. Most of the case closing actions mentioned by the IRS in its response for the 17 organizations do not reflect actual repayments of delinquent taxes and generally do not decrease tax debt under Federal accounting standards. For example, closing cases as currently not collectable does not reduce tax debt; instead, it means that the IRS is no longer actively pursuing collection of delinquent taxes from the tax-exempt organization.

Management Statement: *We would like to note that the report paints an incomplete picture about IRS enforcement efforts on employment tax, particularly in regard to these 25 tax-exempt organizations.*

Office of Audit Comment: TIGTA provided extensive information on the enforcement actions that the IRS had taken related to the 25 organizations and their officers. For example, Figure 3 in the report shows that 32 Federal tax liens and 21 Federal tax levies were filed by the IRS in order to get the 25 tax-exempt organizations to pay their taxes. In addition, we show that Trust Fund Recovery Penalties were filed against 22 of the 52 officers we reviewed in the amount of almost \$2.4 million.



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Management Statement: *Your report makes the illogical conclusion that “tax-exempt organizations can continue to avoid paying these (payroll) taxes” because current law “does not authorize the IRS to revoke tax-exempt status based on an organization’s failure to pay payroll taxes.”*

Office of Audit Comment: The statement in our report is accurate. As the IRS noted, revocation of tax-exempt status is an action of last resort, and the IRS is not authorized to revoke tax-exempt status based on an organization’s failure to pay payroll taxes. The IRS itself acknowledged that more aggressive enforcement actions are generally not taken against I.R.C. § 501(c)(3) and other tax-exempt organizations because the IRS faces the dilemma of seizing property or serving levy actions that could potentially result in closing the entity and its services to the community. We reported that the IRS is currently unable to require changes to the board of directors or the executives responsible for an organization’s tax compliance problems. Although the IRS took significant actions to attempt to collect payroll taxes from the 25 organizations that we reviewed, most have not fully paid their Federal tax debt. Thus, despite the IRS’s extensive collection efforts, tax-exempt organizations are able to avoid paying payroll taxes while maintaining their tax-exempt status. This is particularly troubling since I.R.C. § 501(c)(3) charitable status is a significant benefit, and some of these organizations benefit from millions of dollars of Federal payments from programs like Medicare. Because the IRS faces limitations in the actions it can take, we made the recommendation that the IRS work with the Department of the Treasury to evaluate whether legislation is needed to strengthen the IRS’s ability to enforce payroll tax noncompliance by tax-exempt organizations.

Management Statement: *Here, the organizations may have been victims of embezzlement rather than entities that deliberately siphoned their earnings to managers. Your report includes no facts to show that any of the tax-exempt organizations collaborated or conspired with the responsible officials.*

Office of Audit Comment: We did not conclude on any of the 25 cases that any tax-exempt organizations collaborated or conspired with the responsible officials to siphon earnings to managers or embezzle funds. Our point was that a number of the executives running the tax-exempt organizations with significant tax problems also had significant individual tax problems.