



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

November 7, 2006

Dear Colleagues, Members of the Press and Taxpayers,

FY 2006 was a challenging, as well as an exciting and successful year, for Exempt Organizations (EO). We faced significant organizational changes, including a new EO Director and a new EO Examination's Director, along with extraordinary program demands. Despite these challenges, we reached major milestones on several of our critical initiatives; continued to expand and improve our educational and outreach efforts; and ended the year by tackling major tax legislation the likes of which the tax-exempt community has not seen since 1969.

Two years ago, EO began a transition toward a more balanced approach between enforcement and customer service and education. The success of this transition is evident in how we now do business and in this year's many accomplishments.

EO has become more transparent by keeping the public and regulated community informed about what we are doing, what we are finding and where we are going. To this end, we reported on two high profile and controversial initiatives, the Political Activity Compliance Initiative (PACI) and Credit Counseling. We also launched an aggressive outreach and enforcement effort to stop abusive down-payment assistance organizations, and publicized our hospital project prior to sending questionnaires to over 500 tax-exempt hospitals.

EO is using its resources more effectively. The new units, established in FY 2005 to enhance our enforcement efforts, are now fully operational and expand our enforcement coverage significantly. For example, the Exempt Organization Compliance Area (EOCA) compliance check and educational letters reach more organizations than would be possible through resource intensive examination programs, reserving examination resources for high risk noncompliance areas. The Review of Operations (ROO) unit extends our reach to monitor previously noncompliant organizations, as well as newly approved tax-exempt organizations. In addition, we established the Strategic Planning Working Group, a cross-functional group tasked with detecting emerging issues early and identifying projects for FY 2007.

We improved and expanded our education and outreach efforts by expanding the readership of EO Update (an electronic newsletter with information for tax-

exempt organizations and tax practitioners who represent them), and increasing the use of phone forums, on topics such as executive compensation and political activity by 501(c)(3) organizations, to reach more customers.

EO challenges were intensified by the enactment on May 17 of the Tax Increase Protection and Reconciliation Act of 2005 (TIPRA), and by the recent enactment of the Pension Protection Act of 2006. Despite its title, the Pension Protection Act contains significant changes to the laws that govern tax-exempt organizations. Implementing the new legislation will be our major focus in FY 2007.

Achieving compliance through enforcement balanced with service is an overall goal of the IRS. Over the past few years, we in EO have struggled to attain this balance. Today, through the coordinated efforts of all the EO functions, we have achieved this balance. The diagram below illustrates my vision for compliance with all facets of our organization — strategic planning, examinations, determinations, education and outreach — supporting our efforts toward reaching compliance.

Vision for Compliance



In the following pages, we detail many of our FY 2006 accomplishments, and outline our work plan for FY 2007, which supports IRS's Strategic Plan for FY 2007 – 2009 by focusing on enhanced enforcement of the tax laws, improved customer service, education and outreach, and better business processes through improved technology.

FY 2006 Accomplishments

Political Campaign Activity

Exempt Organizations (EO) responded to increased complaints about political intervention by 501(c)(3) organizations and dramatic increases in the amount of money financing campaigns during election cycles, by launching the Political Activity Compliance Initiative (PACI), to investigate specific, credible allegations of wrongdoing, and by increasing our educational efforts.

On February 22, we issued a report detailing the results of the PACI. In nearly three-quarters of the completed examinations, we found some level of prohibited political activity including:

- distributing improper voter guides or printed materials favoring particular candidates,
- endorsing or opposing candidates from the pulpit,
- criticizing or supporting candidates on a charity's website,
- permitting select candidates to speak at official functions,
- showing support for a candidate by displaying the candidate's campaign sign, and
- contributing to a candidate's campaign.

The PACI report also outlined a plan for the 2006 election cycle that included:

- New procedures that include:
 - shorter classification timeframes,
 - a dedicated review committee to ensure consistency,
 - a designation for egregious and/or repetitive cases, which triggers more oversight and more expeditious handling, and
 - follow-up of noncompliant organizations by the ROO.
- Expanded educational efforts to ensure that charities understand what constitutes prohibited political activity and how to stay in compliance with the tax law.
 - Issued a fact sheet (FS-2006-17), which provides examples of the types of activities the IRS investigated during the 2004 election cycle, to help 501(c)(3) organizations stay in compliance with the federal tax law.
 - Added a page to the Charities and Non-Profits portion of irs.gov, which contains links to IRS published materials on political campaign intervention by tax-exempt organizations.
 - Designed and participated in the March 14 Tax Talk Today program concerning what tax-exempt organizations can and cannot do when an election campaign is underway.
 - Increased coverage of this topic at our Small and Mid-Size Exempt Organizations workshops.

- Added a seminar entitled *Election Involvement by Section 501(c)(3) Organizations (Including Churches)* at the IRS Nationwide Tax Forums.
- Conducted phone forums on September 19 and 20, explaining the rules regarding prohibited political activity.

Credit Counseling

The Credit Counseling Compliance Project, which focused on abuse by tax-exempt credit counseling organizations, succeeded in halting the spread of abuse in this industry. Over the past several years, we saw an increasing number of credit counseling organizations become mere sellers of debt-management plans. These organizations appeared motivated primarily by profit, and offered little or no counseling or education. On May 15, we issued a report detailing the results of the project as follows:

- We revoked, terminated or proposed revocation of more than 40 credit counseling organizations, representing over 40 percent of the revenue in the industry.
- We provided additional guidance in the form of a Chief Counsel Advice Memorandum (CCA 200620001, May 9, 2006), which provides the legal framework to determine whether a credit counseling organization that offers debt management plans to the general public operates in furtherance of educational purposes consistent with 501(c)(3).
- We developed the Core Analysis Tool (CAT), which agents and tax law specialists use to help them evaluate whether a credit counseling organization furthers an educational purpose. We also made the CAT available on our website so credit counseling organizations can evaluate whether they are complying with the law.
- We sent compliance check letters to the remaining universe of tax-exempt credit counseling organizations not previously under examination to determine whether they operate compliant credit counseling organizations.
- We succeeded in halting the growth of abusive credit counseling organizations. Of the 110 applications received since 2003, only three met the requirements for tax-exempt status.
- We worked with the Federal Trade Commission and the Executive Office of the U.S. Trustee to develop a public awareness program including a coordinated website.

Down-Payment Assistance

The IRS was finding that organizations claiming to be charities were being used to funnel down-payment assistance from sellers to buyers through self-serving, circular-financing arrangements. In a typical scheme, there is a direct correlation between the amount of the down-payment assistance provided to the buyer and the payment received from the seller. Moreover, the seller pays the organization only if the sale closes, and the organization usually charges an additional fee for its services. Studies from the Department of Housing and Urban Development and the Government Accountability Office concluded that, rather than helping

low-income families, seller-financed down-payment assistance could actually increase the effective cost of home ownership.

In response to this abusive scheme, EO established a vigorous examination program, and initiated an effort to identify potential abusers through the determination process. We issued formal guidance (Revenue Ruling 2006-27) that contrasts down-payment assistance organizations operating in a manner consistent with the requirements for qualifying as charities with seller-financed arrangements that do not. In addition to the examination program, we denied applications for exemption from over 50 seller-financed down-payment assistance organizations.

Disaster Relief – Hurricane Katrina

Based on lessons learned from previous disasters, the IRS encouraged those wanting to help victims of Hurricane Katrina to use established charities familiar with disaster relief because such organizations are usually able to administer relief programs more efficiently than newly formed organizations. For those who wanted to start new organizations, EO initiated a process to expedite requests for tax-exempt status. We approved over 500 new charities, which better positioned these organizations to raise funds and provide relief to hurricane victims. We put procedures in place to identify and review potentially abusive fundraising schemes. In addition, we provided substantial information via our website, including: frequently asked questions about charitable organizations providing disaster relief, a search engine to identify new exempt organizations, a news release warning consumers of possible scams involving charitable donations, consumer tips on charitable giving, and information about an innovative program through which employees could donate leave to charities.

IRC Section 527 Political Organizations

In FY 2006, the Exempt Organization Compliance Unit (EOCU) sent over 1,700 compliance check letters to section 527 political organizations that had stopped filing Form 8872 (the form used by political organizations to report contributions and expenditures). Over 84% of these organizations responded that they were no longer required to file because they were qualified state and local political organizations or had terminated. This information combined with other updates to our Master File ensured a more reliable database for a new automated notice process to contact non-filers of Form 8871 (the form used by section 527 political organizations to register with the IRS) and non-filers and late filers of Form 8872. To date, we have issued 521 notices to section 527 political organizations.

Executive Compensation Initiative Project

In February 2004, EO established the Executive Compensation Initiative Project as part of an enforcement effort to identify and halt abuses by tax-exempt organizations that pay excessive compensation and benefits to their officers and other insiders. The project included educational and guidance components, complemented by an aggressive examination program.

During FY 2006, EO held a phone forum to provide participants with an overview of the project and the issues and problems we are seeing in this area. We completed most of the examinations, evaluated the results, and expect to issue a report later this year.

Hospitals

EO identified a new hospital project in its FY 2006 Implementing Guidelines.

- The hospital project has two objectives: determine how non-profit hospitals meet the community benefit standards for purposes of section 501(c)(3), and determine how these hospitals set and pay compensation to their executives.
- In May, the EOCU sent over 500 hospitals compliance check letters and questionnaires.
- The majority of hospitals contacted have responded, and we are evaluating those responses.

Counter-Terrorism

- We continued to work with Treasury's Task Force, the IRS Criminal Investigation (CI) Division and other law enforcement agencies to support government-wide anti-terrorism activities.
- We participated in multi-national conferences on Combating Terrorist Financing and Preventing Misuse of Charities held in Vienna, Austria, and Colombo, Sri Lanka.
- We assisted Treasury and CI in providing information on issues concerning non-profits to the Financial Action Task Force (FATF) and Asia/Pacific Group assessment team on the United States' anti-money laundering and counter-terrorism financing standards. The final report, released in July, concluded that the United States is fully compliant with the FATF recommendation on terrorist financing with respect to non-profit organizations.
- We completed our examinations of foreign grant-making organizations and are now evaluating the results of those examinations.

Guidance

In FY 2006, we were involved in issuing guidance on a wide range of technical issues including:

- Revenue Ruling 2006-27, which clarifies that organizations that provide seller-funded down-payment assistance to home buyers do not qualify as tax-exempt charities.
- Notice 2006-1, which provides guidance on the reporting requirements for donee organizations that receive vehicle donations with a claimed value of more than \$500 after December 31, 2004.
- Notice 2006-19, which provides guidance on the meaning of "gross receipts" for purposes of determining whether small insurance companies qualify as tax exempt under IRC 501(c)(15).

- Notice 2006-65, which makes entities aware of and requests comments on new excise taxes and disclosure rules for tax-exempt entities entering into potentially abusive tax shelter transactions.
- Publication 4302, *A Charity's Guide to Vehicle Donations*, which was revised to include tax law changes enacted under the American Jobs Creation Act of 2004 and subsequent guidance provided in Notice 2005-44 and Notice 2006-1.
- Publication 4303, *A Donor's Guide to Vehicle Donation*, which was revised to include tax law changes enacted under the American Jobs Creation Act of 2004 and subsequent guidance provided in Notice 2005-44.
- A fact sheet (FS-2006-17), which provides information to help section 501(c)(3) organizations stay in compliance with the federal tax law regarding the prohibition on political campaign intervention.

Determinations

Over the past several years, the number of applications for tax-exempt status has continued to rise. The increase in applications, coupled with the need to scrutinize applications more closely to ensure that the organization qualifies for tax-exempt status, has resulted in a backlog of cases awaiting assignment. To help reduce the inventory of unassigned cases, we implemented a new three-pronged screening process. Screeners divide cases into three categories: cases we can close without further contact; cases that require minor development; and complex cases that need research and development.

In FY 2006, we continued to look for additional ways to speed the processing of complex cases. We introduced specialization into our groups recognizing that agents who specialize can make determinations more expeditiously. To assist these agents further, we developed guide sheets and reference materials for them to use to decrease the number of contacts as well as the overall processing time. To reduce the backlog without interfering with the ongoing work in Cincinnati, we transferred cases to a very experienced and dedicated group of tax law specialists in our DC office. Because of their years of experience, these specialists were able to resolve a significant number of cases in a relatively short time. We have already seen the results of these efforts. Last year at this time, there were 12,000 cases awaiting assignment. This year, the number has dropped to 7,000.

While we are working to reduce the backlog, we recognize that applicants may be frustrated by the wait time. To address this frustration and reduce the volume of calls to our customer assistance lines, we added information on our website entitled "Where Is My Exemption Application?" that explains the determination process, gives the status of applications requiring additional development, and explains how an organization can check on the status of its application.

To ensure that donors and other interested parties have up-to-date information about section 501(c)(3) organizations that have had their tax-exempt status

revoked, we began listing all recent revocations on the Charities and Nonprofits page of irs.gov.

Modernized e-file (MeF)

EO initiated a robust campaign to educate organizations about the new electronic filing requirement.

- We sent letters to over 1,700 organizations with total assets of \$100 million or more that appeared to meet the 250 filed-returns requirement explaining the new electronic filing rules for the initial year of the requirement. We made follow up calls to a random sample of the organizations to ensure that they received the letter and understood their requirement to file electronically.
- In October and again in November, we conducted e-file phone forums. The first provided a general discussion of electronic filing, and the second focused on the new e-file requirements.
- In May, we issued a news release reminding large tax-exempt organizations of the electronic filing requirement and the expansion of the electronic filing requirement to organizations with total assets of \$10 million or more for returns due on or after December 31, 2006.
- We updated our website with the latest information on MeF including requirements, definitions, frequently asked questions, and information on requesting waivers.

The results thus far indicate that our educational campaign is working. Of the 1,700 organizations we identified as potentially meeting the initial year criteria, 637 organizations had returns due by September 15, 2006. Of these, 611 have either filed an electronic return or requested an extension.

Risk Modeling

Risk modeling involves the development of models that will better enable us to detect high risk compliance patterns and formulate effective enforcement strategies. In FY 2006, we developed several risk models that we will test in 2007.

Cyber Assistant: During FY 2006, we completed a prototype of the long awaited web-based tool, Cyber Assistant, that guides applicants for tax-exempt status through Form 1023, *Application for Recognition of Tax Exempt Status under 501(c)(3) of the Internal Revenue Code*. We also began an active search for partners, such as software developers and other interested parties, to pilot, test and market Cyber Assistant.

Education and Outreach

During FY 2006, EO continued to provide a high level of education and outreach to the exempt organization community.

- We held 18 Small and Mid-Size Exempt Organization workshops reaching over 2,000 individuals involved in the day-to-day activities of 501(c)(3) organizations.

- We participated in the IRS Nationwide Tax Forums reaching nearly 12,000 individuals at our TE/GE exhibit, our workshop on completing Form 990 and our seminars on *Deterring Abuses Within and Misuses of Exempt Organizations*, and *Election Involvement by Section 501(c)(3) Organizations (Including Churches)*.
- We held five “phone forums” reaching over 1,000 individuals. The phone forums were on the following topics:
 - 2006 changes to Form 990,
 - General information about electronic filing,
 - New electronic filing requirements,
 - Executive compensation, and
 - Election involvement by 501(c)(3) organizations.
- We issued 21 editions of our electronic newsletter, reaching over 14,000 subscribers.
- We updated and improved the Charities and Non-Profits pages of irs.gov to ensure that our customers had the latest information on issues affecting the exempt organization community. For example, immediately after the President signed the Pension Protection Act, we posted information about the tax law changes that affect exempt organizations.
- We added Life Cycle of a Private Foundation to the Charities and Non-Profits page of irs.gov. This life cycle links to information and documents most foundations will need as they proceed through various phases of their “life cycle.”
- We provided speakers for panels, conferences, meetings and other events to discuss critical topics such as executive compensation, tax-exempt hospitals, and political campaign activity by 501(c)(3) organizations.

Other Priorities

In addition to the accomplishments described above, we continued to work in other areas identified as potentially abusive.

- We looked more closely at applications from supporting organizations claiming public charity status to determine whether they actually serve charitable purposes and are responsive to the organizations they claim to serve. We conducted examinations of supporting organizations and assessed penalties against those who promote abusive supporting organizations.
- In coordination with other areas of the service, we continued to look at both donors and organizations that may be involved in abusive donor-advised funds. We are actively examining these types of arrangements and looking at payouts, the amount of donor control over investments, and the relationship of the funds with for-profit investment firms.
- We are part of a Service-wide team that is attacking all aspects of conservation easement misuse. This team initiated a robust examination program, investigating promoters, appraisers, contributors, and recipients.

FY 2007 Priorities

FY 2007 looks to be a busy and exciting year. We will be reporting out on a number of our ongoing projects as well as beginning some new projects. In addition, enactment of the Tax Increase Protection and Reconciliation Act of 2005 and the Pension Protection Act of 2006, which contains significant changes to the laws that govern tax-exempt organizations, will require substantial time and resource commitments to implement the changes as well as provide guidance, education and outreach.

New projects for FY 2007 include:

- implementing new legislation,
- gaming,
- employment taxes,
- telephone excise tax refund,
- community foundations, and
- college and university unrelated business income tax (UBIT).

The Form 990 redesign project continues, with a goal of having a draft form and instructions available for comment in 2007.

We will continue to work with Chief Counsel and Treasury to issue new guidance on topics that further our strategic goals as well as ones that are of concern to the tax-exempt community. In particular, the FY 2007 Priority Guidance Plan includes:

- Guidance on political activities by section 501(c)(3) organizations.
- A revenue procedure on processing exemption applications that will replace Revenue Procedure 90-27.
- Final regulations under sections 501(c)(3) and 4958 on revocation standards. (Proposed regulations were published on September 9, 2005.)
- Guidance on advance and definitive rulings for publicly supported organizations.
- Guidance under section 509(a)(3) regarding supporting organizations.
- Guidance under section 527(l) with respect to the reasonable cause standard for penalties imposed on political organizations for failing to comply with notice and reporting requirements.
- Regulations under section 529 regarding qualified tuition programs.
- Guidance on section 516 of the Tax Increase Prevention and Reconciliation Act of 2005, regarding the involvement of accommodation parties in tax shelter transactions.

We will continue to provide quality education and outreach programs including:

- a new interactive web-based training program modeled on our Small and Mid-Size Exempt Organizations workshop,
- information on the new legislative changes,

- phone forums on the hottest topics, and
- updates to the Charities and Non-profits page on irs.gov.

EO will continue to use technology to improve its business processes. We will implement the TE/GE Determinations System (TEDS), which will replace and improve the current methods used for processing and tracking applications for tax-exempt status. We expect to train examination personnel and roll out the TE/GE Reporting and Electronic Examination System (TREES), an information system that will allow examination personnel to manage in-process inventory, and track issues, examination results, and education and outreach activities.

FY 2006 was an exciting year, and the EO team worked hard to reach the goals we had set for ourselves in enforcement, customer service, education and outreach. I congratulate each member of the EO team on the role he or she played in making this a successful year. I also want to express my gratitude to the exempt community for its support and input. I hope that FY 2007 will be as productive and exciting as this year has been. Each of the programs mentioned above, and others, are described in more detail in the pages that follow.

Sincerely,

Lois G. Lerner
Director,
Exempt Organizations

FY 2007 EXEMPT ORGANIZATIONS (EO) IMPLEMENTING GUIDELINES

The mission of Exempt Organizations is to provide Exempt Organizations customers top quality service by helping them understand and comply with applicable tax laws, and to protect the public interest by applying the tax law with integrity and fairness to all.

November 2006

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New Legislation

FY 2006 ended with major tax legislation the likes of which the exempt organization community has not seen since 1969. Many of the provisions of the Pension Protection Act of 2006 are effective as of the date of enactment (August 17, 2006); thus, implementing these changes and educating the tax-exempt community about the changes is a major EO priority for FY 2007. In particular, we will train employees, and provide guidance, education and outreach to the tax-exempt community in the following areas impacted by the new law:

- Donor-advised funds
- Section 509(a)(3) supporting organizations
- Credit counseling
- New annual filing requirement for small organizations
- New disclosure requirements for sharing information with states
- Provisions that relate to curbing abuses of non-cash donations including:
 - easements, both open space and façade,
 - recapture of any tax benefit from a charitable contribution of exempt-use property that is not used for an exempt purpose, and the related penalty against anyone who intentionally identifies donated property as exempt-use property knowing that it is not,
 - contributions of fractional interests in tangible personal property, and
 - transactions where the charity is serving as an accommodation party in an abusive tax-avoidance transaction (legislative change from the Tax Increase Protection and Reconciliation Act of 2005 (TIPRA)).

In addition, the legislative changes will require significant time and resources to revise the forms and related instructions used by non-profits, including Forms 990, 990-PF, 990-T, Schedule A and Forms 1023 and 4720.

New Projects

- 1. Gaming:** Historically, examinations of organizations that conduct gaming activities have identified a high level of non-compliance; from failing to file Form 990 to failure to pay employment taxes or report unrelated business income. In addition, each state regulates and enforces charitable gaming differently. Some states are highly regulated, others have minimal regulations, and others prohibit charitable gaming. We plan to begin this project by looking at gaming activities conducted by organizations in ten different states. The variety of issues coupled with the differing regulatory schemes in each state will make this a challenging compliance effort. In addition, we plan to test the effectiveness of a gaming risk model by examining approximately 50 organizations the model projects as having a high likelihood of noncompliance.
- 2. Employment Taxes:** Most tax-exempt organizations must withhold and pay employment taxes the same as any other employer. Generally, organizations that pay wages to employees must withhold, deposit, and pay employment

tax, including federal income, social security and Medicare taxes, and in some situations, Federal Unemployment Tax Act (FUTA) tax.

The IRS and Social Security Administration (SSA) jointly administer the Combined Annual Wage Reporting (CAWR) program, which matches reported earnings and reported withholding of taxes. Currently, the IRS uses this information to resolve situations where the information reported to the IRS on Form 941, *Employer's Quarterly Federal Tax Return*, is different from what was reported to the SSA on Form W-2, *Wage and Tax Statement*, and Form W-3, *Transmittal of Wage and Tax Statement*. However, there are instances where the IRS does not have a Form 941 to match with the SSA data.

In our continuing effort to ensure that exempt organizations report and pay employment taxes properly, we will initiate a project using the CAWR data to identify potentially non-compliant organizations. In the past, questions existed with the quality of this data and our ability to research it successfully. We believe we now have the capabilities to pursue these cases and will test those capabilities. In addition, our risk-modeling program (described on page 8) will use all available data to help select productive employment tax cases for examination.

- 3. Telephone Excise Tax Refund:** On May 25, 2006, the IRS announced that it would stop collecting the federal excise tax on long-distance telephone service because of decisions in five federal appeals courts holding that the tax does not apply to long-distance service as it is billed today. Taxpayers are eligible for a refund of telephone excise taxes paid on long distance charges billed after February 28, 2003, and before August 1, 2006. Notice 2006-50 explains that tax-exempt organizations requesting a credit or refund of this excise tax must do so on Form 990-T, *Exempt Organization Business Tax Return*, even if they are not otherwise required to file Form 990-T. In FY 2007, we will issue instructions on what tax-exempt organizations need to do to apply for a credit or refund, provide educational information and samples of what needs to be submitted to help them comply, and examine some organizations to ensure they are complying with the requirements.
- 4. Community Foundations:** EO plans to conduct a compliance project of community foundations to ensure that they are complying with section 501(c)(3) of the Internal Revenue Code (IRC). Community foundations began as groups of small charitable trusts established at local banks or trust companies to benefit community residents. However, over the last decade, we have seen a significant increase in the number, size, and complexity of community foundations. This compliance project will provide us with information on how these organizations operate and allow us to follow up on organizations that may have compliance issues.

- 5. College and University Unrelated Business Income Tax Project:** In 2007, EO will develop a project to review the treatment and allocation of income and expenses in the college and university area. The project is intended to review current practices of calculating unrelated business taxable income, as well as the allocation of income and expenses more generally by and between the organizations (profit and non-profit) comprising large university systems. The project is expected to roll out to the field in 2008.

Critical Initiatives

In FY 2007, EO will continue to focus on those issues that we have identified as critical initiatives.

- 1. Political Activity:** We will work on referrals identified during the 2006 election cycle. The Review of Operations unit will follow-up on certain organizations previously examined to ensure they are staying in compliance with the tax law prohibiting political intervention by 501(c)(3) organizations.

We also will contact over 300 501(c)(3) organizations, identified through state election databases, that may have violated the prohibition on political intervention by contributing to individual candidates, political parties, and political action committees (PACs) during 2004 and 2005. In addition, we will review state election databases to identify 501(c)(3) organizations that may have made improper political contributions during 2006, and will establish an ongoing process for monitoring state election databases, which will allow us to timely address future violations.

- 2. Credit Counseling:** We will conduct examinations on organizations whose response or failure to respond to compliance check letters indicated potential noncompliance. We will continue to closely scrutinize applications for tax-exempt status from credit counseling organizations, especially in light of the requirement that all individuals must undergo credit counseling before filing for bankruptcy, and because of the additional standards (added by the Pension Protection Act of 2006) credit counseling organizations must meet to qualify for tax-exempt status under 501(c)(3) or (4). We will train our determination staff regarding the new standards for credit counseling organizations as well as provide information to credit counseling organization and the public on the new standards.

As a result of a public awareness program, developed in coordination with the Federal Trade Commission and the Executive Office of the U.S. Trustee, we have added a page to our website that contains information for consumers and credit counseling organizations and includes links to these agencies websites.

- 3. Executive Compensation:** The Executive Compensation Compliance Initiative, begun in February 2004, was divided into two phases. During the

first phase, we sent compliance check letters to over 1,200 organizations seeking:

- Missing compensation information from returns,
- Missing attachments detailing loans to officers,
- Missing attachments detailing sales or use of property by disqualified persons, or
- Unanswered questions to Part III Schedule A and question 89b, regarding excess benefit transactions.

The second phase involved nearly 800 single-issue examinations. The public charity examinations looked at potential excess benefit transactions under IRC section 4958. The private foundation examinations looked at any Chapter 42 violations resulting from excessive compensation.

We have completed the examinations and expect to issue a report on our findings by the end of 2006. In FY 2007, we will work cases involving loans to officers and excess benefit transaction. In addition, we will look at how organizations set and determine executive compensation as part of other projects. For example, the tax-exempt hospital project (discussed below) looks at how hospitals set and determine compensation in addition to its primary focus of determining how hospitals meet the community benefit standard.

- 4. Tax-Exempt Hospitals:** Tax-exempt hospitals and health care organizations are an important and highly visible element of the tax-exempt community. However, over the years questions have arisen about how to differentiate for-profit from non-profit hospitals causing the public and Congress to question whether tax-exempt status for hospitals is still appropriate.

In May 2006, we sent over 500 compliance check letters and questionnaires to hospitals asking about their operations to determine whether and how they qualify for tax-exempt status under the community benefit standard. In addition, we asked questions about how they set and determine compensation for their executives and other insiders.

In FY 2007, we will analyze the data from the compliance check questionnaires and determine the appropriate next steps, which could include education, guidance, examinations, and/or additional compliance check activity.

- 5. Down-Payment Assistance:** Organizations that provide seller-funded down-payment assistance to home buyers do not qualify as tax-exempt charities according to Revenue Ruling 2006-27. Such programs have non-charitable purposes of facilitating real estate sales for the benefit of sellers and related financing entities.

In FY 2006, we conducted examinations of organizations that provide down-payment assistance. During FY 2007, we will focus on completing the remaining examinations, analyzing the results, and issuing a report.

- 6. Donor-Advised Funds:** Donor-advised funds allow individuals to make a gift to a fund, which is organized as a charity, and then advise the fund on distributions from the donor's account. Contributions to donor-advised funds are deductible to the individual donor because the contribution is a gift to a charity, and the fund has legal control over the distributions. However, we are concerned about the misuse of these funds, specifically when the funds are used for the private benefit of the donor, and when the fund is set up to avoid the rules applicable to private foundations. We are actively examining these types of arrangements and looking at payouts, the amount of donor control over investments, and the relationship of the funds with for-profit investment firms.

In FY 2007, besides continuing to conduct examinations, we will be educating our employees as well as organizations that sponsor donor-advised funds about the legislative changes made by the Pension Protection Act of 2006. We also will make changes to Form 990, Schedule A, and Form 1023 that correlate with changes required by the Pension Protection Act. Finally, we will work with Treasury and Chief Counsel on the Congressionally mandated study in this area and in the area of supporting organizations.

- 7. Section 509(a)(3) Supporting Organizations:** Section 509(a)(3) supporting organizations have been the subject of much debate over the years. A supporting organization is given public charity status because of its special relationship to another public charity—such as a high school athletic booster club that supports a school's athletic program; a hospital auxiliary that supports a tax-exempt hospital; or a university endowment fund that raises funds for a university.

Classification as a "supporting organization" requires that the organization have one of three special relationships with its supported organization, which are intended to ensure that the supporting organization is responsive to the supported organization. In addition, the organization must avoid being responsive to the private interests of its founders rather than to the public interests it claims to serve.

EO is concerned that some 509(a)(3) organizations are controlled by their founders, and are set up to avoid the more strict regulations that apply to private foundations, such as the restrictions on self-dealing and excess business holdings. We find that some of these organizations have little activity and do not provide meaningful support to the charity they claim to support.

In FY 2007, we will continue our cross-functional examination effort. In addition, we will educate our employees as well as 509(a)(3) supporting organizations regarding extensive legislative changes in this area made by the Pension Protection Act of 2006. As in the area of donor-advised funds, we will work on a study required under the Pension Protection Act of 2006.

8. Charities Facilitating Abusive Transactions – Accommodation Parties:

EO is concerned about the role of tax-exempt organizations in facilitating abusive tax shelters. The Tax Increase Protection and Reconciliation Act of 2005 (TIPRA), enacted on May 17, 2006, includes new excise taxes and disclosure rules that target certain potentially abusive tax shelter transactions to which a tax-exempt entity is a party. The changes made by TIPRA were generally effective upon enactment and have broad application to tax-exempt entities and their managers.

In FY 2007, we will continue to identify and follow-up on charities that may be facilitating abusive tax shelters. We are designing a new form for organizations to use to notify the IRS that they are a party to a prohibited tax-shelter transaction. In addition, we will work on guidance regarding the new excise tax and disclosure rules.

Guidance

To help the charitable community in complying with the complex tax laws governing exempt organizations, EO, in conjunction with Chief Counsel and Treasury, will develop and issue guidance to customers.

The FY 2007 Priority Guidance Plan includes:

- Guidance on political activities by section 501(c)(3) organizations.
- A revenue procedure on processing exemption applications that will replace Revenue Procedure 90-27.
- Final regulations under sections 501(c)(3) and 4958 on revocation standards. (Proposed regulations were published on September 9, 2005.)
- Guidance on advance and definitive rulings for publicly supported organizations.
- Guidance under section 509(a)(3) regarding supporting organizations.
- Guidance under section 527(l) with respect to the reasonable cause standard for penalties imposed on political organizations for failures to comply with notice and reporting requirements.
- Regulations under section 529 regarding qualified tuition programs.
- Guidance on section 516 of TIPRA regarding the involvement of accommodation parties in tax shelter transactions.

In addition, we will work closely with Chief Counsel and Treasury on any guidance needed to implement the tax law changes in the Pension Protection Act

of 2006 and the required studies of donor-advised funds and supporting organizations.

Other Projects

- 1. Section 527 Organizations:** As a follow-up to our FY 2006 project, the EOCU will contact qualified state or local political organizations (QSLPO) to verify their continuing status as a QSLPO.
- 2. Exempt Organization Compliance Area (EOCA):** Early in FY 2007, EOCA will send over 6,000 educational letters to organizations with total assets of \$10 million or more that appear to file 250 or more returns a year explaining the new electronic filing requirements for tax years ending on or after December 31, 2006. For those organizations that are required to file electronically but fail to do so, the EOCA will contact them and attempt to secure an electronic return (or an explanation of why the organization is not required to file electronically) prior to assessing any penalties.

EOCA will begin looking at changes to an organization's Form 990 over a series of years. The project will begin with organizations that have a substantial difference in ending and beginning assets. In addition, EOCA will conduct compliance checks on a broad range of issues, including:

- large organizations that file Form 990, but did not file an application for tax-exemption status though required to do so,
- various non-filer situations,
- organizations whose public support drops below the required percentage,
- section 501(c)(7) organizations with investment income, that have not filed Form 990-T, *Exempt Organization Business Income Tax Return*, and
- organizations that terminated but still have substantial assets.

- 3. Determinations:** In FY 2007, we will continue our inventory reduction efforts by developing additional guide sheets, adding more specialization into our groups, transferring some older cases to experienced tax law specialists in DC, and implementing a process for case building of complex cases prior to assigning them to an agent.
- 4. Form 990 Redesign:** As we pursue our goals of increasing transparency and obtaining enhanced compliance data, EO will continue its work on the comprehensive redesign of Form 990 with the expectation of having a draft of the new form and instructions available for comment in 2007. In addition, legislative changes made by the Pension Protection Act of 2006, will require substantial interim changes to Form 990 and the instructions as well as several other forms used by tax-exempt organizations.
- 5. Risk Modeling:** We developed several risk models during FY 2006. These models review existing data from Forms 990 and other sources and indicate

the likelihood of compliance issues on a return. To test the effectiveness of these models, we plan to select a sample of 200 highly scored returns and conduct full scope examinations. Based on our models, we anticipate finding non-compliance in the areas of employment tax and unrelated business income tax. In addition, we will test the gaming risk model by examining 50 highly scored organizations involved in gaming.

6. **TE/GE Determination System (TEDS):** TEDS will replace and improve the current system used to process and track applications for tax-exempt status. In FY 2007, TEDS will undergo testing and we will begin training end users. We will complete the migration to TEDS by the end of 2007.
7. **TE/GE Reporting and Electronic Examination System (TREES):** TREES is an electronic Windows based software program that EO examination personnel will use to manage in-process inventory, and track issues, examination results, and education and outreach activities. Training will take place early in FY 2007, with national deployment to all EO examination employees by the end of FY 2007.
8. **Cyber Assistant:** In FY 2006, we developed a prototype of the web-based tool, Cyber Assistant, an interactive program for completing Form 1023, and began a search for software developers and other interested parties that would pilot, test and market this program. During FY 2007, we will work with those that accept our proposal to pilot, test and market Cyber Assistant.

Education and Outreach

In FY 2007, EO will continue to emphasize education and outreach to the exempt organization community. In particular, we will expand our efforts to increase the readership of our electronic newsletter (EO Update), debut our new web-based training, and continue to offer phone forums on topics of critical interest to the exempt organization community. We also will implement a communication plan designed to keep EO employees informed of important Division issues including Division goals, obstacles and accomplishments. Our activities will fall into three broad categories: publications and forms, presentations, and web-based programs.

1. **Publications and Forms:** Revising our plain language publications and updating forms and instructions used by tax-exempt organizations will be one of our top priorities in FY 2007 because of the changes made by the Pension Protection Act of 2006. We will work closely with the Forms and Publications Division to ensure that the forms and instructions accurately reflect the tax law changes.

- 2. Presentations:** EO will continue to:
- participate in the IRS Tax Forums, a three-day session offered annually in six locations around the country by providing EO seminars and workshops and jointly sponsoring a booth with other TE/GE offices;
 - provide workshops for small and mid-size exempt organizations in cities throughout the country;
 - conduct phone forums on issues of critical interest to practitioners and the tax-exempt community including phone forums that will provide information on the tax law changes.

EO receives over 200 invitations annually to speak at meetings, conferences, serve on panels or at other events. We will coordinate these speech invitations and assist speakers with preparation and editing of speeches. In addition, we will proactively seek speaking opportunities to large audiences that further EO's FY 2007 compliance priorities.

In FY 2007, we will expand our speaker cadre. Though our speaker cadre has been very successful over the past few years, we recognize that increased requests for presentations on EO topics and the affects of attrition make it necessary to expand the cadre to ensure that we have a well trained group of individuals to make these presentations.

- 3. Web-Based Programs:** One of the most exciting events in FY 2007 will be the debut of our web-based training program, modeled after our Small and Mid-Size Exempt Organization workshop. It will contain five interactive modules that will provide users with an understanding of what 501(c)(3) organizations must do to keep their tax-exempt status and comply with tax obligations. We designed the program for representative of 501(c)(3) organizations that cannot attend the workshop or need a refresher.

EO will continue to expand the quality and quantity of information on the Charities and Non-Profit pages of irs.gov. In particular, we will:

- Add guidance regarding legislative changes as soon as it is available.
- Expand the *Life Cycle of a Private Foundation*, to include information from Publication 578, *Tax Information for Private Foundations and Foundation Managers*, which was discontinued.
- Add life cycles for 501(c)(4), (5), and (6)s.

In conjunction with improving our website, we will focus on increasing our EO Update readership. The articles in this newsletter are generally brief and link to the Charities and Non-Profits pages of irs.gov for more information. By expanding our readership, we will help ensure that exempt organizations receive important information timely. To subscribe, go to www.irs.gov/eo and click on "EO Newsletter."

As you can see, we have a lot to accomplish in FY 2007, and we believe that the foundation we have set over the past several years, position us for an exciting and successful year.