Mr. Chairman, Senator Baucus, distinguished members of the Committee: Thank you for the opportunity to discuss a number of issues relating to tax-exempt organizations. The country rightfully takes pride in its tax-exempt sector. It is composed of millions of dedicated volunteers and staff who faithfully and impressively carry out critically important work. On them, many within the United States and throughout the world rely.

My remarks will focus on problems with abuse that we are encountering in the tax-exempt area. In making these observations, I am not talking about the inspiring work that the charitable community does day-in and day-out. Nor am I overlooking that the overwhelming majority of these organizations try hard to comply fully with the letter and spirit of the tax law.

But we must recognize that we are now at an important juncture. We can see that abuse is increasingly present in our sector, and we must work to address it. We will act vigorously, for to do otherwise is to risk the loss of the faith and support that the public has always given to the charitable community. And if that is lost, the bountiful vitality of the American charitable sector will wither.

The Administration strongly encourages and supports donations to our charities. But you and I share the same concern. Some entities now use their privileged status to achieve ends that Congress never imagined when it conferred tax-exemption. They are wantonly abusing the generosity and faith of the public. I therefore appreciate your efforts, and those of the Joint Committee on Taxation, to consider changes that will make our oversight of this area stronger, our ability to remediate abuse swifter, and the strength of the charitable sector more secure.

As I begin, let me also extend my appreciative congratulations to the Panel on the Nonprofit Sector, convened by Independent Sector, for its fine interim report. I have read it from cover to cover. It represents an impressive effort to move the tax-exempt community to a better place. The IRS strongly supports the Eight Guiding Principles of accountability and governance, and commends Independent Sector and the Panel on the Nonprofit Sector for their role in encouraging adherence to these standards of excellence.

Good governance and accountability are important given the size and impact of the tax-exempt sector in our economy. Although our exempt organization master-file data is imprecise, the IRS lists 1.8 million tax-exempt entities, and the number is constantly growing. More than 300,000 entities have been added to our rolls since 2000. Total
assets of these organizations approximated $2.5 trillion in 2002, with revenues of $1.25 trillion. Collectively these organizations file more than 800,000 annual returns.

The IRS Strategic Plan for 2005 – 2009 recognizes the significance of this sector for tax administration. The Strategic Plan sets out four key objectives designed to enhance tax law enforcement over the next five years. One of these objectives directly addresses the charitable sector. That objective is to

Deter abuse within tax-exempt and governmental entities and misuse of such entities by third parties for tax avoidance and other unintended purposes.

Despite the importance of this sector, until recently our enforcement budget was not keeping up with its growth. From 1995 through 2003, there was an increase of over 40 percent in the number of exempt organization returns filed, yet IRS staffing of the exempt organizations function steadily declined.

The chart below shows how we are turning this around. Using 1995 as a benchmark, the chart shows the percentage increase in exempt organization returns filed, together with the percentage changes in staffing and staffing per exempt organization, on a year-by-year basis. Although our staffing devoted to exempt organizations has declined, we have begun to reverse this trend.

Although I will discuss this at greater length later, let me say here that by September we will see a 30 percent increase in enforcement personnel for Exempt Organizations over September 2003 levels.
I will divide my testimony today into four parts. First, we outline external factors currently impacting this sector. Second, we outline our findings regarding compliance issues facing this sector and specific steps we have taken. Third, we outline our broader response to these compliance problems. Finally, we identify unresolved policy issues that should be part of any discussion on reform.

**External Factors Impacting the Sector---A Less Compliant Environment**

A number of factors are impacting compliance in the tax-exempt area. As might be expected, these factors do not necessarily operate independently of one another. Taken together, however, they add up to a culture that has become more casual about compliance and less resistant to non-compliance. These are attitudes that we must work together to change.

**Increase in size and complexity of the tax exempt sector.** This sector has grown rapidly over the past decade, and this growth has impacted the manner in which organizations do business. The number of exempt entities on our master-file has increased by almost 500,000 since 1995, to 1.8 million today. In FY 2002, the reported value of the assets of these organizations was approximately $2.5 trillion. Further, most recent figures show reported annual revenues for Internal Revenue Code (Code) section 501(c)(3) organizations at $897 billion. This growth impacts our ability to regulate and creates other pressures within the sector. For example, competition for donations has increased and with that pressure we have seen changes in fundraising practices and reporting. We have seen many organizations that might be considered inefficient when considering the ratio of fundraising expenses to charitable outlays. In addition, as individual organizations grew, the skyline changed with more organizations entertaining complex business structures and transactions. The prime example in this area is the transformation of health care providers and the increased merger activity in the health care sector that we saw in the 1980s and 1990s.

**The lack of an adequate enforcement presence in recent years.** In the Tax Exempt and Government Entities Division (TE/GE), as in the rest of the IRS, our enforcement presence faded in the late 1990’s. A number of factors contributed to this decline. In the area of exempt organizations, we were, and continue to be, struggling with yearly increases in the number of applications for tax exemption. In TE/GE’s Exempt Organizations (EO) function, overall staffing declined and fewer and fewer employees were deployed to do traditional enforcement work.

This decline in enforcement presence, combined with the significant growth of the tax-exempt sector noted above, created opportunities for noncompliance. We simply did not do enough “policing” in the area to support the good actors in their quest to voluntarily comply with the rules.

**Lax attitudes towards governance.** An independent, empowered and active board of directors is the key to insuring that a tax-exempt organization serves public purposes, and does not misuse or squander the resources in its trust. Unfortunately, the nonprofit
community has not been immune from recent trends toward bad corporate practices. Like their for-profit brethren, many charitable boards appear to be lax in certain areas. Many of the situations in which we have found otherwise law-abiding organizations to be off-track stem from the failure of fiduciaries to appropriately manage the organization. For example, as we will discuss below, we have found issues relating to how executive compensation is set and reported by nonprofits. Similarly, issues exist as to whether sufficient due diligence and care is taken in filing tax and information returns.

**The rise of abusive transactions: tax shelters and artifices to pay personal expenses.**

As in the governance area -- and arising in part from the same lax practices -- some parts of the regulated community have become involved with abusive transactions.

In the tax shelter area, abusive programs often require a “tax-indifferent party” to make the scheme work. Tax-exempt organizations are natural candidates. We are concerned that tax-exempt entities are being used as accommodation parties to enable abusive tax shelters. Of the 31 categories of listed transactions, nearly half may involve tax-indifferent parties either as accommodation parties or as active participants.

We believe that the tax-exempt organization that participates or allows itself to be used in an abusive transaction may be inappropriately trading on its privileged tax-exempt status. Some shelter promoters use tax-exempt organizations to create abusive shelters where, for a fee, the tax-exempt entity lets the promoter exploit its tax-free status.

Other abusive transactions involving charities are less complex, but just as corrosive to the credibility of the tax system and to the public’s faith in our charitable sector. These transactions often share the same guiding principle: a donor receives a deduction for a charitable contribution while maintaining control over the contributed assets, often using them for personal gain. We list several examples below, including abusive donor-advised funds and supporting organizations.

**The terrorist acts of September 11, 2001.** One of the most disconcerting revelations since the horrors of September 11 has been that certain terrorist organizations have used charities to raise and move funds or otherwise support terrorist activity. Especially troubling is the fact that the forty charitable organizations designated as financing terrorist activity include six U.S.-based charities. Although those represent a minuscule part of the charitable sector, curtailing possible corruption and abuse is a critical element in how we now regulate the charitable sector. September 11 has had an impact on the way we design, process, and review forms and the business processes by which we recognize exemption and review continued operational compliance.

**Improved transparency in the tax exempt sector.** A positive development in recent years is the improvement in “transparency” within the tax-exempt sector. “Transparency” refers to the ability of outsiders -- donors, the press, interested members of the public -- to review data concerning the finances and operations of a tax-exempt organization. By creating a means by which the public may review and monitor the activities of tax-exempt organizations, we promote compliance, help preserve the
integrity of the tax system, and help maintain public confidence in the charitable sector. To achieve these goals, we began in the mid-to-late 1990s to image Forms 990, the annual information returns filed by many tax-exempt organizations. We put this information on CDs, and provide it to members of the public, including a number of watchdog groups that monitor charitable organizations. These groups put the information up on their websites, where it is available to the press and to the public. This process has resulted in increased press and public scrutiny of the tax-exempt sector, which we believe is highly desirable. It has also increased the ability of the IRS and state regulators to access Form 990 data, because they are more readily available.

Current Compliance Problems in the Charitable Sector --- Abuses and Misuses of Exempt Organizations

Now I want to turn to some of the specific reasons why our emphasis on the tax-exempt sector is required. Each year the IRS publishes a list of its “Dirty Dozen,” the schemes that have the dubious honor of sinking to the lowest level of tax abuse. This year, for the first time, abuses involving exempt organizations have a significant representation on the list, occupying four spots.

One can divide these abuses into two broad categories. The first group involves charities that abuse their tax-exempt status. The second group involves charities that are misused by third parties. Both of these groups are targets of the strategic objective I mentioned a moment ago: to deter abuse within tax-exempt and governmental entities, and also to deter the misuse of tax-exempt and governmental entities by third parties.

Charities that Abuse their Status

One group of organizations that abuse their status is charities established to benefit their donors. Generally, the abuses share the same theme: a donor receives a charitable contribution deduction while maintaining control over the contributed assets, often using them for personal gain. I will list several examples.

Abusive donor-advised fund arrangements. A donor-advised fund typically is a separate fund or account established and maintained by a public charity to receive contributions from a single donor or a group of donors. These funds can offer a convenient way for a donor to make charitable gifts. However, for the payment to a donor advised account maintained by the charity to qualify as a completed gift to the charity, the charity must have ultimate authority over how the assets in each account are invested and distributed in furtherance of its exempt purposes. Although the donor may recommend charitable distributions from the account, the charity must be free to accept or reject the donor’s recommendations.

We have found that certain promoters encourage individuals to establish purported donor-advised fund arrangements that are used for a taxpayer’s personal benefit, and some of the charities that sponsor these funds may be complicit in the abuse. The promoters inappropriately claim that payments to these organizations are deductible
under section 170 of the Code. Also, they often claim that the assets transferred in the
funds can grow tax free and later be used to benefit the donor in the form of
compensation for purported charitable projects, to reimburse them for their expenses, or
to fund their children’s educations.

We have a compliance team that is vigorously addressing abuses of these funds.
Currently, we are examining the returns of over 200 donors, and have several
organizational examinations underway, with more planned. We have denied the
exemption application of one organization that is now challenging our action in court,
and have proposed revocation of tax-exempt status in another case.

Section 509(a)(3) supporting organizations established to provide benefits to founders.
Supporting organizations are public charities that, in carrying out their exempt purposes,
support another exempt organization, usually another public charity. The category can
cover many types of entities including university endowment funds and organizations
that provide essential services for hospital systems. The classification is important
because it is one way a charity can avoid classification as a private foundation, a status
that is subject to a much more restrictive regulatory regime. There are three types of
these organizations, depending upon the relationship between the supporting organization
and the organizations it supports. Briefly, Type I supporting organizations are controlled
by the supported organization in a manner comparable to a parent and its subsidiary.
Type II supporting organizations share common supervision and control with the
supported organizations. Most problems we are finding are in Type III organizations
where the relationship is least formalized. We have found some issues with the Type I
organizations as well, where the supported organization may be controlled by the
promoter.

Some promoters in this area have encouraged individuals to establish and operate
supporting organizations purportedly described in section 509(a)(3) that they can control
for their own benefit. There are a variety of methods of abuse, but a common theme is a
“charitable” donation of an amount to the supporting organization, and a return of the
donated amount to the donor, often in the form of a purported loan that may never be
repaid.

For example, we have seen contributed amounts that have ultimately been returned and
then used by the donor to purchase residential property. To disguise the abuse, the
transaction may be routed through one or more intermediary organizations controlled by
the promoter, some of which may be offshore.

We are aggressively combating this abuse. An IRS compliance team has obtained the
client lists of several promoters. We have approximately 100 examinations underway,
with more planned. We have revoked the exempt status of one supporting organization,
which is challenging our determination in Tax Court. Two cases involving individuals
who claimed charitable contribution deductions to supporting organizations are currently
docketed in Tax Court. Fifteen individuals are under examination for promoter penalties,
and three cases involving supporting organizations are being considered for criminal investigation.

**Corporation sole abuses.** Corporations sole are a repeat entry on our dirty dozen list. A corporation sole is an entity authorized under certain state laws to allow religious leaders to hold property and conduct business for the benefit of a religious entity. The leader can incorporate under state law in his capacity as a religious official. A corporation sole may own property and enter into contracts as a natural person, but only for the purposes of the religious entity. Title in property that vests in the officeholder as a corporation sole passes to the successors in office, and not to the officeholder’s heirs. The purpose of a corporation sole is to ensure continuity of ownership of property dedicated to the use of a religious organization.

The corporation sole form of organization serves a valid function for legitimate religious entities. However, some promoters are urging use of corporation sole statutes for tax evasion. Individuals incorporate under the pretext of being a “bishop” of a religious organization or society. The idea promoted is that the arrangement entitles the individual to exemption from Federal income taxes as a nonprofit, religious organization as described in section 501(c)(3).

The position is without merit. In Rev. Rul. 2004-27, 2004-12 I.R.B. 625, the IRS announced that persons relying on this scheme to avoid Federal income tax could be subject to civil and criminal penalties. Similar sanctions will be applied to the promoters of this abuse. We have almost 50 promoter investigations underway involving corporation sole abuses and the Department of Justice has obtained permanent injunctions against seven promoters. Three persons have been indicted in connection with corporation sole scams. In addition, almost 250 returns have been identified as having links to abusive corporation sole arrangements and have been placed in the examination process. Of these, 90 returns are under active examination and several are under consideration for the application of fraud penalties.

**Charitable trust problems and abuses.** Some promoters have set up purported charitable or split-interest trusts that can be used for the taxpayer’s personal benefit. There are a variety of schemes, without legal merit, designed to allow individuals to deduct amounts that ultimately will be used for their personal expenses. The charitable trust typically is a nonexempt charitable trust that serves as a holding entity of the individual’s assets. Individuals retrieve these assets at will, generally through loan transactions, gifts, or by having the trust pay for expenses directly.

We have also seen a variety of abusive promotions involving charitable remainder trusts, which have both charitable and non-charitable elements. These trusts are typically funded with highly appreciated property. One marketed scheme attempts to abuse the tax rules governing the character of distributions from the trust to the transferor by timing distributions in a year when the trust has little or no ordinary income or capital gain. The claim is that the transferor thus avoids any significant tax liability from the sale of the trust’s appreciated property. This type of abuse is specifically prohibited by Treasury
regulations, and this transaction and other similar transactions have been designated as listed transactions.

There are other variations on this theme and we are still investigating the extent to which these schemes have been sold. In sum, trusts that are designed for charitable purposes are being manipulated for tax avoidance by their creators. We have over 40 charitable remainder trust examinations underway involving variants of the above abuse in which the total amounts sheltered exceed $1 billion.

**Abusive credit counseling organizations.** Certain credit counseling organizations are abusing their tax-exempt status, albeit in a much different manner. Increasingly, it appears that some credit counseling organizations have moved from their original purposes, that is, to counsel and educate troubled debtors, to inappropriately enrolling debtors in proprietary debt-management plans and credit-repair schemes for a fee. These activities may be disadvantageous to the debtors and are not consistent with the requirements for tax exemption. Further, a number of these organizations appear to be rewarding their insiders by negotiating service contracts with for-profit entities owned by related parties. Many newer organizations appear to have been created as a result of promoter activity.

We are taking strong actions to eliminate the abuses. To date, we have identified 60 credit counseling organizations for examination. Of those, almost 50 examinations have begun, accounting for over 50 percent of the industry by gross receipts. We have revoked or proposed revocation of tax-exempt status for credit counseling organizations representing over 20 percent of the industry’s gross receipts. We are using the knowledge we have gained from examining industry abuse to screen new applications more effectively.

To help our credit counseling compliance activities, our recent revision of Form 1023, the application for recognition of tax exemption filed by charities, now asks questions to help identify applicant organizations that have close ties to service organizations owned by insiders. On the Form 990, the annual information return filed by exempt organizations, we now ask whether organizations provide credit counseling, debt management, credit repair, or debt negotiation services to help us identify organizations that have shifted to or added credit counseling activities after having established tax-exempt status as a different kind of charitable organization.

Finally, we are partnering with the states and the Federal Trade Commission (FTC) to leverage our resources. We are developing strategies to address consumer concerns, coordinate our enforcement actions, and share information.

Organizations recognized by the IRS as described in section 501(c)(3) often are excluded from coverage under FTC rules, as well as state and local consumer protection laws. We remain very concerned that the potent combination of exemption from income tax and from consumer protection laws is encouraging those who are motivated by profit rather than charity to seek tax exemption. Our vigilance on credit counseling is even more
important given that the bankruptcy legislation that recently passed the Senate includes a provision mandating credit counseling for many debtors. If this legislation is enacted into law, it is imperative that we ensure that those individuals in bankruptcy receive the required counseling from legitimate organizations.

Misuse of Charities by Third Parties

I have discussed charities that abuse their tax-exempt status. Others charities are misused by third parties, often unknowingly but sometimes with the charity’s knowledge and consent.

Overstated deductions. A common problem occurs when a taxpayer takes an improper or overstated charitable contribution deduction. This happens most frequently when the donation is of something other than cash or readily marketable securities. Last year, when I appeared before this Committee, I listed several specific concerns in this area, and I would like to take this opportunity to thank the Congress for the provisions in the American Jobs Creation Act of 2004 that will reduce compliance problems with donations of vehicles and intellectual property. Let me discuss some problems that remain.

Conservation easements. In recognition of the need to preserve our heritage, Congress allowed an income tax deduction for owners of significant property who give up certain rights of ownership to preserve their land or buildings for future generations.

The IRS has seen abuses of this tax provision that compromise the policy the Congress intended to promote. We have seen taxpayers, often encouraged by promoters and armed with questionable appraisals, take inappropriately large deductions for easements. In some cases, taxpayers claim deductions when they are not entitled to any deduction at all (for example, when taxpayers fail to comply with the law and regulations governing deductions for contributions of conservation easements). Further, the conservation easement rules place the charity in a watchdog role. In a number of cases, however, the charity has not monitored the easements, or has allowed property owners to modify the easement or develop the land in a manner inconsistent with the easement’s restrictions.

Another problem arises in connection with historic easements, particularly façade easements. Here again, some taxpayers are taking improperly large deductions. They agree not to modify the façade of their historic house and they give an easement to this effect to a charity. However, if the façade was already subject to restrictions under local zoning ordinances, the taxpayers may, in fact, be giving up nothing, or very little. A taxpayer cannot give up a right that he or she does not have.

Last year, we published Notice 2004-41, 2004-28 I.R.B. 31, which describes another abuse. A charitable organization purchases property and places a conservation easement on the property. The charity then sells the property subject to the easement for a price that is substantially less than the price paid by the charity for the property. As part of the sale, the buyer makes a second payment designated as a charitable contribution to the
charity. The total of the payments fully reimburses the charity for its cost. In some cases, the second payment is really part of the negotiated purchase price of the property and therefore is not a contribution.

Now let me explain what we are doing about these problems. Notice 2004-41 describes a specific abuse, but it also provides a warning. The IRS will look at the substance, rather than the form, of abusive transactions, and will impose appropriate penalties against the abusers.

We are modifying our tax forms to aid in the identification of abuse. We added new questions to Form 1023, the application for recognition of tax exemption filed by charities, that will help us identify organizations with conservation donation programs. We are considering changes for our next revision of Form 990, the annual information return filed by exempt organizations, that will allow the IRS and the public to better identify organizations that take easements and to understand what they do with them. We also will revise Form 8283, the form the donor files to support a non-cash charitable contribution, to clarify what is permissible and to disclose better information on the type of property donated.

While this will enable us to better target our enforcement efforts in the future, we have an active enforcement program now as well. We are currently looking at the activities of more than a dozen promoters. We are examining charities that we believe may have been involved in particular abuses and those charity officials who may have unduly profited from their positions with a charity. We are currently examining 48 easement donors and also are reviewing deductions taken for nearly 400 open space easements, to be followed with a review of over 700 façade easements. We will use all civil and criminal tools at our disposal to combat abuses.

Other non-cash charitable contributions. We also have persistent problems in taxpayers’ valuation of deductions taken for non-cash charitable contributions. Valuation issues are often difficult. Overvaluations may arise from taxpayer error or abuse, as well as from aggressive taxpayer positions. Additional enforcement concerns are whether consideration has been received in return, and whether only a partial interest has been transferred.

I have read with much interest the Joint Committee on Taxation’s description of problems in the area of clothing, household items, and other contributions of property and I agree that these are resource-intensive for us to audit. Overvaluations are difficult to identify, substantiate, and litigate. Further, donors and the recipient charities do not have adverse interests that would help establish a correct valuation.

As I mentioned, the Congress addressed two major abuses with legislation that targets vehicle donations and patent and other intellectual property donations. This has greatly helped us administer this area of the tax law, but problems remain with respect to the valuation of other property.
Abusive tax shelters involving tax-exempt accommodation parties. An “accommodation party” is a term generally used to describe a tax-indifferent party’s involvement in a transaction that does not necessarily affect the entity’s primary function, but is designed to provide tax benefits to a taxable third party. We have seen an increased use of various tax-exempt entities, including charities and other tax-exempt organizations, private and government retirement plans, Indian tribal governments, and municipal governments, to achieve abusive results.

In one listed transaction, Notice 2003-81, involving tax-avoidance using offsetting foreign currency option contracts, we have found both otherwise-legitimate and suspect charities to have been involved.

Disclosure is an important way for the IRS to identify participants in abusive transactions. The IRS requires participants to disclose their participation in listed and other reportable transactions on Form 8886, which must be filed with the organization’s annual return. We have begun to name accommodation parties as participants in listed transactions (see Notice 2004-30). However, not all potential accommodation parties have a return-filing requirement. Those that do not file returns include churches, small exempt organizations, state and local governments, state and local government retirement plans, and Indian tribal governments. Thus, even where we specifically designate accommodation parties as participants, these entities are not required to disclose their participation in these transactions. As I reported to you last year, we have worked around this problem to some degree by revising Form 8886 to require the other participants to identify the tax-exempt parties in a listed transaction.

Increased disclosure to the IRS will help in this area, even without a sanction. However, it is as yet unclear whether disclosure to the IRS will prove a meaningful deterrent to exempt entities engaging in this behavior. We welcome a discussion of the issues raised by this Committee and the Joint Committee on Taxation staff, as well as the Panel on the Nonprofit Sector.

Compensation issues. There has been much publicity about high salaries and generous compensation at some charities and foundations. An exempt organization is entitled to pay reasonable compensation for the services it receives. Moreover, what some may consider excessive levels of compensation may meet the requirements of current law in this area. High compensation is not necessarily an abuse under the law if it is warranted based on the value of services performed for the exempt organization. The key to this determination is whether the compensation is comparable to that paid by similar organizations for similar work. The organizations being used for comparison may be nonprofit and for-profit organizations, but it is not always clear that the comparison actually used in a particular case is appropriate for the particular position. In addition, there is a major risk that organizations that effectively allow key executives too great a voice in determining their own compensation will not end up with objective and reasonable compensation levels.
Excess compensation by an exempt organization is not permissible. An organization that overcompensates its officers and directors risks revocation of its tax-exempt status. In the case of charities and social welfare organizations, the IRS also can impose an excise tax on certain individuals who receive more than their due.

Last year, we began a comprehensive enforcement project to explore the seemingly high compensation paid to individuals associated with some exempt organizations. This is an aggressive program that includes both traditional examinations and correspondence compliance checks. Its purpose is to enhance compliance by identifying practices organizations use to set compensation; learning how organizations report compensation to the IRS and the public; and creating positive tension for organizations as they decide on compensation arrangements. This project also has an educational component.

We are contacting a broad spectrum of nearly 2000 public charities and private foundations and asking for detailed information and supporting documents on their compensation practices and procedures, and specifically how they set and report compensation for specific executives. We also are asking organizations for details concerning the independence of the governing body that approved the compensation, and for details concerning the duties and responsibilities of these executives. We also are looking at organizations that failed to supply, or did not fully complete, compensation information on Form 990. We are requiring them to file amended returns immediately to supply information missing on any part of the Form 990.

We have completed our review of over 500 of these contacts. It is too early to state any findings definitively, but we are seeing issues in the reporting of loans and deferred compensation, as well as whether all “perks” are being appropriately reported. There may also be an issue of spreading compensation among several affiliated organizations, which decreases transparency.

**Terrorist financing.** We want to ensure that U.S. charities have no role in financing terrorist activity, and we continue to assist in the fight against terrorism and those who fund it. On the criminal side, we have ongoing investigations concerning potential terrorist financing. Efforts by special agents in our Criminal Investigation function have played an important part in designations of several entities as terrorist organizations by Treasury's Office of Foreign Assets Control. Since 2001, in conjunction with other agencies our actions have contributed to the sentencing of 44 individuals in terrorism-related cases, 32 of them for money-laundering.

We have created a Lead Development Center to pilot a counter-terrorism project, including a focus on the abuse of charities. It uses advanced analytical technology and subject matter experts to support ongoing investigations and proactively identify potential patterns and lawbreakers. The Center is staffed with personnel from both our criminal and civil functions, and it integrates its work with the larger Federal law enforcement community, chiefly through our participation in the Joint Terrorism Task Forces led by the FBI. Using data from tax-related information that is protected by disclosure laws, the Center can analyze information not available to other law enforcement agencies. By
combining that data with public-source information and with data gathered by other law enforcement agencies, the Center can perform a complete analysis of all financial information relating to specific investigations.

On the civil side, the tax-exempt status of six entities has been suspended automatically by operation of section 501(p). We are also exercising due diligence to ensure that individuals designated as terrorists have no place in U.S. charities. Applications for tax-exempt status are screened for terrorist names. We have adopted procedures and are developing the electronic capability to review filed Forms 990 and 990-PF for terrorist names. Name matches are coordinated with the appropriate office for verification or further action.

We are seeking better information about U.S. charities with international activities. Our recent revision of Form 1023 asks for more specific information on foreign activities, and we expect that our forthcoming revision of Form 990 will have similar questions. We also are seeking better baseline information about the practices of organizations that make grants to foreign entities, and the level of oversight the organizations exercise over the use of the funds abroad. For this purpose we are examining over 100 charities that make grants or have operations overseas. Depending upon what we find, we will institute new compliance programs or issue new guidance or educational material, as appropriate.

In addition, we asked for public comments on international grant-making. Among other things, we are interested in the practices that charities find work best for them to ensure that their assets are used only for their intended charitable purposes. The IRS intends to issue a publication that discusses some of the methods used by charities with international operations.

**Political activity of non-profits.** Section 501(c)(3) organizations are statutorily prohibited from intervening in political campaigns. Each election cycle we become involved with significant allegations of wrongdoing and this problem shows no indication of abating. In 2002, a mid-term election year, our records indicate that we received approximately 70 complaints alleging campaign activity by charities. In 2004, a presidential election year, that number was over 200. These are difficult cases, and our actions often trigger questions and concerns from the public and the Congress.

In the 2004 election cycle, we took a more active stance than we have in the past in an attempt to reduce the number of violations. Early in the campaign year we issued a news release, as well as a mailing to political parties explaining the prohibition against campaign intervention. During this past summer, we began a project designed to respond to reports of campaign intervention on an expedited basis. We also pursued other educational avenues, including the sponsorship of seminars and the distribution of plain-language publications that explained the rules. Our objectives were to ensure that charities understood the rules and the need to avoid political campaign activity, without chilling the ability of charities to speak out on important issues of public policy.
A committee of experienced career employees selected about 130 organizations for examination by our revenue agents. The selected organizations represented all segments of the political spectrum. We intend to repeat this project in future election cycles, with modifications that include, among other things, an earlier starting date in the election year and greater up-front publicity.

**IRS Response: Revitalizing and Refocusing Exempt Sector Enforcement and Enhancements to Transparency**

Revitalization – Recent Budget Increases

Because of the priority we have given to the charitable sector, as expressed in the key objective in the Strategic Plan to deter abuse and misuse of tax-exempt entities, the budget for our EO function increased significantly in FY 2004 and FY 2005. Although the IRS budget increased only one-half of one percent in FY2005, the TE/GE budget increased 9 percent, the EO budget increased 13.8 percent, and the EO examinations budget increased 21 percent. In EO Examinations, this increase will translate, by September, into a 30 percent increase in staffing over September 2003.

We have translated the increase in funding into concrete results. In FY2004, we added 70 new agents to conduct exempt organizations examinations, and additional employees for our new EO Compliance Unit, which reviews Forms 990. This year, the FY 2005 budget supports the creation of the EO Financial Investigations Unit, and I have reallocated resources to EO to hire 69 additional compliance employees.

For next fiscal year, FY 2006, the Administration has requested a 4.3 percent increase in the IRS budget, with nearly an 8 percent increase in enforcement. If the Congress approves the request, the amount we plan to dedicate to the tax-exempt area would be used to combat abusive promotions involving tax-exempt entities, to start examinations quickly when we detect a risk, to give agents better information for their first contact with taxpayers, and to increase vigilance against the misdirection of exempt organizations’ assets for illegal activities or private gain.

Refocusing of Efforts – Pursuing the Right Cases

We also are refocusing the way we approach exempt organizations. We are expanding our presence in the community, and making data about exempt organizations more accessible to our agents and to the public.

To enhance compliance, we are interacting with a greater number of exempt organizations. We established two new offices to help us do this. First, our new EO Compliance Unit is designed to review Forms 990 and correspond with organizations on inconsistencies, errors, and other matters that do not require an examination. For example, the EO Compliance Unit may correspond with a non-filer to solicit a Form 990 when we know from other sources, such as a state bingo regulatory agency, that the organization has gross receipts that exceed the $25,000 filing threshold. The Compliance
Unit has also sent educational letters to charities that report the receipt of substantial contributions that, coupled with low fundraising expenses, could indicate a reporting problem. Our letters provide instruction on the proper reporting of fundraising income and expenses. We will monitor future returns of these organizations to see if their behavior has changed. This Unit has also played a key role in our compensation initiative.

At the tougher end of the compliance spectrum is our Financial Investigations Unit, which we are now organizing. This Unit will specialize in our most difficult and significant cases in the civil context, including fraud and terrorism, and will serve as a strike force when we need to move quickly.

These new units will be aided by two new groups. The Data Analysis Unit, which became operational in 2004, will use innovative data capture to better select cases for examination. The comparison of state bingo databases to our master-file is an innovative example of the type of work this Unit will perform. A separate, newly-funded group will identify and follow up with selected Form 990 filers in the first years of their operations, bridging the gap between what an applicant organization tells us when it applies for exemption and how it actually operates.

We have also refocused our staff to work the most troublesome areas. EO is devoting approximately one-third of its examination staffing to EO’s priority compliance areas this year, all of which are among the issues I have referred to earlier, up from a much lower percentage in FY 2004.

Enhancements to Transparency

Transparency is a lynchpin of compliance within the sector. Therefore, part of our work is to improve exempt organization transparency, including better data quality and better data availability. With our e-filing initiatives, planned changes to Form 990, expanded imaging of returns, and changes to the application process and the Form 1023, we expect substantial progress toward this goal.

All exempt organizations can now file their annual returns electronically. Electronic filing was available for Form 990 and 990EZ filers in 2004, and is now available this year for private foundations, which file Form 990-PF. We want to encourage e-filing because it reduces taxpayer errors and omissions and allows us, and ultimately the public, to have ready access to the information on the return. For this reason, we have required e-filing in certain cases. Under proposed and temporary regulations, by 2007 we will require electronic filing for larger public charities and all private foundations. Due to statutory restrictions, discussed below, at this time we can only do so for organizations that file at least 250 returns with us annually.

We are also working on improving the Form 990. The current form is not particularly “user-friendly,” and does not give us all the information IRS agents need to do their jobs; the public is similarly constrained. We are at work revising the form. We anticipate that
the revised form will have specific questions or even separate schedules that focus on certain problem areas. For example, filers should not be surprised to find specific schedules or detailed questions relating to credit counseling activities, supporting organizations, compensation practices, and organizational governance. The timing of the revision of the Form 990 is somewhat dependent on our partners, including the states, 37 of which use the Form 990 as a state filing, and software developers.

We are also expanding our Form 990 imaging capabilities. We already image the returns of public charities and private foundations. This month, for the first time, we are imaging the returns of our many categories of exempt organizations that are not section 501(c)(3) organizations. This will allow our agents immediate access to these returns, and will allow us to respond quickly to public requests for returns. While important at this time, it is our hope that imaging will become a relic of the past as electronic filing becomes the norm.

In November 2004, we revised Form 1023, the form that charities file when they apply for tax exemption. This was a comprehensive redesign. We ask many new questions that focus on potential problem areas, and others that are designed to reduce the need for our personnel to request more information from the applicant. We also ask questions that we hope will lead our charity applicants to focus on self-governance issues and organizational best practices.

As we move forward, we will increase compliance efficiency by making closed application files more accessible. As budget permits, we intend to replace our antiquated microfiche storage system by imaging the application files so that they can be readily viewed by our compliance personnel and the public.

**IRS Focus Areas for Discussion of Reforms -- Unresolved Issues**

Notwithstanding our revitalized and refocused program, we believe there are several areas that should be included as part of any discussion of reform in the tax-exempt area. The first such question is whether there are additional bright-line tests that are available to aid the public in complying with, and the IRS in administering, the law. A debate on reform also should include the following questions, identified below.

**Have changes in practice or industry created gaps in the statutory or regulatory framework?** There has been huge growth in the tax-exempt sector, but much less change in the law governing those organizations that qualify for tax-exempt status. Since 1969 there has been only limited review of the rules relating to tax-exempt organizations. Some within the community have argued that it is time for a more thorough review, and we welcome that.

As we regulate various parts of the TE/GE community, compliance in some areas becomes difficult to administer where industry practice, or the industry itself, changes, but the rules remain constant decade after decade. An example we noted above is the credit counseling area. This industry grew up in a different time, under different rules,
but now has evolved into something substantially different from what it was. There also have been great changes in technology that should be considered. One important issue, for example, is how rules that are several decades old apply in an Internet, often virtual, environment.

**Does the IRS have the flexibility to respond appropriately to compliance issues?** We believe a discussion about reform should address whether we have the proper range of tools to enforce compliance in a measured way, where appropriate. In many areas of our jurisdiction, our remedial tools are not effective. Often our only recourse is revocation of tax-exemption, a “remedy” that may work a disproportionate hardship on innocent charitable beneficiaries. Moreover, even where we have an intermediate sanction, it may not work as intended.

Similar discussions may be worthwhile with respect to the rules on political intervention in campaigns by exempt organizations and the reporting requirements for political action committees.

With regard to abusive tax shelter transactions, the accuracy-related penalties imposed by the Code are not sufficient to deter a tax-exempt accommodation party, which has no taxable income to understate. Likewise, IRS’s compliance sanctions for exempt organizations do not fit these situations. Participating in a transaction as an accommodation party rarely affects the tax status of a charity or other tax-exempt entity.

In some areas, activities of exempt organizations have transformed greatly in recent decades, but the rules governing tax exemption have not, leaving the IRS with difficult and fact-intensive administrative challenges. An example is health care, an evolving industry that has changed dramatically over the last few decades. Some tax-exempt health care providers may not differ markedly from for-profit providers in their operations, their attention to the benefit of the community, or their levels of charity care. Further, some exempt providers have entered into joint ventures with for-profit organizations, sometimes placing their entire health care operation in the venture and transforming themselves into what is effectively a tax-exempt holding company with a charitable grant-making function. Although this is not impermissible, we insist that the charitable entity ensure that the charitable purposes of the venture are not sacrificed for the sake of maximizing profits. However, it can be difficult for the IRS and the courts to wrestle with fact-intensive cases.

Finally, in our attempts to ensure that exempt organization funds are not diverted to improper purposes, including terrorism, we do not have tools comparable to those applicable to private foundations to sanction public charities that fail to monitor their grants. For those organizations that need not file for exempt status and do not file annual returns, such as small organizations that normally receive not more than $5,000 annually and churches, the problem is compounded because we have little ability to monitor their operations against diversion of assets.
**Should more be done to promote transparency?**  Transparency is a lynchpin of compliance within the tax-exempt sector. However, there are legitimate questions about whether to enhance transparency, and if so, how to proceed. As I noted to you last June, limitations on our ability to communicate with state charity officials prevent us from fully leveraging the relationship and jurisdiction we share with them. Further, there are segments of the TE/GE community that we are unable to track, including several categories of legal non-filers (for example, those exempt organizations that are not required to file a Form 990, such as churches and organizations with less than $25,000 in gross receipts). Our master-file is replete with errors concerning these organizations.

Finally, one of our key transparency initiatives is the establishment of electronic filing for Forms 990 and 990-PF. The recent report by the Panel on the Nonprofit Sector, referenced above, supports mandatory electronic filing for all returns for nonprofits, and we have issued temporary regulations requiring such filing for certain groups. While this will markedly advance the ability of the Service, the states, and the public to access Form 990 data in real time, our ability to mandate e-filing is limited at this time by statutory restrictions that prevent us from mandating electronic filing for any organization that files fewer than 250 returns with us. The Administration’s 2006 Budget proposal echoes this concern. The Administration’s proposal would lower the current 250-return minimum for mandatory electronic filing, but would maintain the minimum at a level high enough to avoid imposing undue burden on taxpayers.

**Does the IRS have the resources it needs to do the job?**  While this is a topic worthy of discussion, I have outlined what we have done to expand our resources in the tax-exempt area. I believe we have done a credible job of recognizing the task before us and preparing to meet that challenge. To continue this work, I would ask the Committee to support the Administration’s 2006 budget proposal, which calls for an 8 percent increase in our enforcement budget.

**Conclusion**

To conclude, let me briefly outline where I believe the IRS must head in the next five years if it is to be successful in reining in abuse and appropriately regulating the tax-exempt sector.

First, while we must continue to maintain a high level of quality service to the sector, we also must continue to strengthen our enforcement activities. To do this we need to concentrate on the following tasks. We need to improve our business processes. We need to develop and increase partnerships with other regulatory agencies, such as the FTC, the Federal Election Commission, and state charity officials, so that we can better leverage resources. We need to increase our ability to identify potentially problematic areas and high-risk cases. We need to continue to ensure a fair allocation of resources to exempt organization examinations to increase our audit presence in the community. And we need to improve our case-building ability through better access to researchable data.
Second, we need to increase electronic submissions. This is not only with respect to Form 990 and 990-PF, for which we now have the capability to accept e-filing, but also Form 1023 and other forms as well. This will increase the amount of data accessible to IRS employees, other regulatory agencies and the public, and will allow us to focus on problem areas faster.

Finally, we need to further tailor our compliance efforts by focusing on specific segments of the EO community. This will allow us to target our resources, including educational resources, to those areas where they will have the greatest impact.

I thank the Committee for its attention. I am pleased to respond to your questions.