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

COMMISSIONER
TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

November 18, 2011

The Honorable Charles Boustany, Jr., MD
Chairman
Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

I am responding to your letter to Commissioner Shulman dated October 6, 2011, requesting information about the tax-exempt sector. We appreciate your interest and support for the IRS efforts in the administration of the exempt organizations tax law.

Reports of the IRS data you requested are created and published by our Statistics of Income (SOI) Division. SOI publishes a wide range of tables, articles, and data that describe and measure elements of the U.S. tax system and are available to the public at http://www.irs.gov/taxstats/index.html. Unless otherwise indicated, SOI data is current through FY 2010 and is generally based on valid statistical samples.

Also, unless otherwise stated, any data compiled from the annual filings of Form 990 returns and supplementary schedules or forms will be provided only for the 2008 tax year, the most recent year in which all voluntarily reported information has been processed.

1) Overview of the Tax-Exempt Sector

a) Provide a detailed breakdown of the number of active tax-exempt organizations in good standing with the IRS, broken down by type (e.g., 501(c)(4), 501(c)(10)).

Enclosed as Exhibit 1(a)-1 is Table 25: Tax-Exempt Organizations and Nonexempt Charitable Trusts, Fiscal Years 2007-2010 from the 2010 IRS Data Book. The FY 2010 totals do not take into account organizations automatically revoked under Internal Revenue Code section 6033(j) beginning in June 2011, organizations that terminated or whose tax-exempt status was revoked through the examination process during FY 2011, or new organizations recognized as tax-exempt in FY 2011. Data Book information is updated annually, with the FY 2011 information expected in March 2012.

b) **Provide a detailed breakdown of the IRS Tax Exempt and Government Entities Division's budget for 2008 through 2011. Specify the total number of employees dedicated to tax-exempt organization work and how these resources are allocated across the division.**

Pursuant to clarification from Legislative Affairs that this question is intended to reflect the TE/GE budget for FY 2008 – FY 2011 and the staffing information for only the EO division, we offer the following information. The enclosed Exhibit 1(b)-1 provides a breakdown of TE/GE budget data for FY 2008 – FY 2011. Exhibit 1(b)-2 provides EO staffing information as of the last day of each fiscal year.

c) **How many tax-exempt organizations have been audited since 2008? Provide a breakdown of all audits opened for each type of tax-exempt entity, the issues identified for audit, and the current status of such audits. What was the average length of a tax-exempt audit during this period?**

Our systems track examination information by return rather than by organization, and information is entered into the system at the time each return is closed. Enclosed as Exhibit 1(c)-1 is IRS FY 2008, FY 2009 and FY 2010 Data Book Table 13: Returns of Tax-Exempt Organizations, Employee Plans, Government Entities, and Tax-Exempt Bonds Examined, by Type of Return. According to the Table 13 data, IRS TE/GE, EO examined the following numbers of tax-exempt organization returns and related taxable returns during FY 2008 – FY 2010:

- FY 2008: 7,861
- FY 2009: 10,187
- FY 2010: 11,449

With respect to the issues identified for audit, the enclosed Exhibit 1(c)-2 contains a list of all the Principal Issue Codes (PIC codes) used for closed examinations involving tax-exempt organizations for FY 2008 – FY 2011. The Internal Revenue Manual provisions governing the use of PIC codes are located at section 4.75.16.9.[1] There are 96 PIC codes for agents to use as part of the process of closing a case. PIC codes are designed to provide historical data to create a model to distinguish compliant from non-compliant returns. In no-change cases, agents are instructed to select the PIC code that captures the issues on which the agent spent time during the examination. In a change case, the agent is instructed to select the PIC code that captures the issue or issues resulting in the change. Agents may choose up to four PIC codes, and if more than one PIC code is chosen, the agent is to list them in order of priority, beginning with the most important. In both the no-change and change cases, the determination of which PIC codes are applicable to a particular case is a judgment made by the agent.

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[1] The Internal Revenue Manual is available at http://www.irs.gov/irm/index.html.

The enclosed Exhibit 1(c)-2 shows the ten most frequently employed PIC codes:

- 42: Delinquent 940/941 Returns
- 83: Employment Tax – Other Issues
- 39: Delinquent 990/990-EZ Returns
- 21: Operational Test
- 34: Other
- 78: Employment Tax – Worker Classification Issues
- 66: Claim for Refund
- 5: Delinquent Filing of Return (Other)
- 57: Gaming – Pull Tabs
- 79: Employment Tax – 1099 Issues

The average length of time for completing examination returns that were closed in FY 2011 is 210 days.

d) How many new tax-exempt organizations did the IRS recognize in each of the last three years for which data is available? Provide a breakdown of all new applications for tax-exempt status by organization type and year for those years. Describe the process by which an entity is granted tax-exempt status. What is the IRS procedure for conducting periodic reviews of an organization's tax-exempt eligibility?

Enclosed as Exhibits 1(d)-1 is Table 24: Closures of Applications for Tax-Exempt Status, by Organization Type and Internal Revenue Code Section, for FY 2008 through FY 2010 from the 2008, 2009 and 2010 IRS Data Book. The information in Table 24 for each fiscal year is tracked at the end of the determination process; that is, the information reflects the number of cases closed in each fiscal year, not the number of applications received.

Process for IRS Tax-Exempt Recognition

With regard to recognition for tax-exempt status, enclosed for your general reference as Exhibit 1(d)-2 is IRS Publication 557, Tax-Exempt Status for Your Organization. Most organizations seeking recognition of exemption from federal income tax must use specific applications forms prescribed by the IRS; primarily, Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, and Form 1024, Application for Recognition Under Section 501(a). Some organizations do not have to use specific application forms and apply for tax-exempt status by letter to the address shown on Form 8718, User Fee for Exempt Organization Determination Letter Request. A copy of the organization document should be enclosed and the letter should be signed by an officer of the applicant organization. All applications for exemption are sent to EO Determinations, headquartered in Cincinnati, Ohio.

If an application for exemption does not contain the required information, it may be returned with a letter of explanation without being considered on its merits.

Alternatively, if the application is substantially complete, the IRS may retain the application and request additional information as needed. If an application for exemption raises issues on qualification for exemption or foundation status for which no published precedent exists or for which nonuniformity may exist, EO Determinations will refer the application to EO Technical in Washington, D.C.

If the IRS receives information sufficiently establishing that an organization meets the requirements for exemption from federal income tax, the IRS will issue a determination letter recognizing the organization's exempt status and providing its public charity classification, if applicable. A proposed adverse determination letter will be issued to an organization that has not provided sufficiently detailed information to establish that it qualifies for exemption or if the information provided establishes that it does not qualify for exemption.

The IRS also grants group exemptions to organizations that have or plan to have related organizations that are very similar to each other. Groups of organizations with group exempt letters have a "head" or main organization, referred to as a central organization. To qualify for a group exemption, the central organization and its subordinates must be affiliated with the central organization, subject to the central organization's general supervision or control, and exempt under the same paragraph of section 501(c), through not necessarily the paragraph under which the central organization is exempt.

A central organization seeking a group exemption request follows the same application format as a single organization – it sends its Form 1023 or Form 1024 application exemption to the IRS. Upon receipt of an application Form 1023 or 1024 and a request for group exemption, the IRS first determines whether the central organization and the existing subordinates qualify for tax exemption. Once the IRS grants the exemption, the central organization is responsible for: (1) ensuring that its current subordinates continue to qualify to be exempt; (2) verifying that any new subordinates are exempt; and (3) updating the IRS on an annual basis of new subordinates, subordinates no longer to be included, and subordinates that have changed their names or addresses. Enclosed for your additional reference as Exhibit 1(d)-3 is IRS Publication 4573, Group Exemptions, TE/GE Division.

In terms of follow-up and as a regular part of its annual workplan, the Review of Operations (ROO) performs follow-up compliance reviews of a statistical sample of organizations that were granted tax-exempt status in the past 3-5 years. Based upon results of reviews, organizations may be referred for examination where appropriate.

In addition to the statistical sample, ROO performs compliance reviews on organizations that have recently gone through the determination process, including organizations that are recognized as tax-exempt because their applications meet all the legal requirements for tax-exempt status, but the agent has concerns about future activities of the organization so follow up is appropriate.

2) Compliance

a) **Provide a detailed explanation of how the IRS is using the new information obtained from the new Form 990 to improve current enforcement efforts and future compliance.**

We undertook a comprehensive redesign of Form 990, Return of Organization Exempt from Income Tax, that was effective beginning with tax year 2008. One element of the redesign was to provide a structured format for reporting information -- both the additional information being requested and the information that previous versions of the form had required without specifying the format to be used. By providing that structure, the information reported on the Form 990 is more readily comparable, which enables us to use data analytic techniques to identify areas of potential noncompliance. The redesigned Form 990 also offers the taxpayer a better understanding of what information to provide and the public with a more accurate picture of an organization's activities.

As organizations have had an opportunity to transition into and provide information using the new reporting requirements, we are now developing and testing risk models to improve our examination case selection process. For instance, such risk models include analyzing issues related to: compliance practices of self-declared section 501(c)(4), section 501(c)(5) and section 501(c)(6) organizations; unrelated business income and filings of Form 990-T; and governance, particularly composition of boards. This effort is in line with TE/GE's wider strategy of using data-driven tools to target high-risk areas.

b) **Provide a detailed explanation of how the redesigned Form 990 increased transparency**

The redesigned Form 990 provides a structure for providing information that makes it more readily comparable across different organizations. By adopting the format of a core form with a series of schedules, the redesigned Form allows the public, press and others to more easily locate the information they are interested in. The redesigned core form also allows an organization to describe its exempt accomplishments and mission up front and provides more opportunities throughout the form for the organization to explain its activities.

For the 2010 Form 990, examples of our efforts to refine the Form to increase transparency include changes to the following Schedules:

- Schedule C, Political Campaign and Lobbying Activities:
  - Instructions for Part II-A clarify that this Part needs to be completed by all Form 990 filers for which the 501(h) lobbying expenditure election was valid and in effect during the 2010 tax year, whether or not the organization engaged in lobbying activities during that tax year.

- Schedule F, Statement of Activities Outside the United States: Schedule F and its instructions were revised to:
  - Clarify that the number of independent contractors in a foreign region should be reported, along with the number of employees and agents in that region.
  - Require reporting of the total book value of investments in a foreign region.
  - Clarify how to report total number of foreign offices, agents, employees and independent contractors.
  - Clarify that types of indirect expenditures for foreign activity that do not have to be reported if they are not separately tracked include expenses for listing study abroad programs on a school website or in a paper catalog.
  - Clarify that foreign program related investments are reportable in Part II of Schedule F.
  - Part II instructions state that a filer should report not only grants and other assistance to foreign organizations or entities, but also to U.S. organizations or entities for foreign activity.
  - Parts II and III instructions clarify that organizations using the accrual method of accounting that make foreign grants to be paid in future years should report the grants' present value in Part II and report any accruals of additional value in future years.
  - Parts II and III instructions clarify that the filing organization should report foreign grants regardless of the source of the grant funds (whether restricted or unrestricted) or whether the filing organization selected the grantee.
  - A new Part IV requires reporting of whether the organization engaged in foreign activities that require filing of other IRS forms.

- Schedule R, Related Organizations:
  - New column (g) in Part II asks whether each related tax-exempt organization is a section 512(b)(13) controlled entity of the filing organization.
  - New column (k) in Part III asks for the filing organization's percentage ownership interest in each related partnership.
  - New column (d) in Part V asks how the organization determined the amount of each type of related party transaction reported in Part V.
  - Instructions provide examples to illustrate how the filing organization can control or be controlled by multiple persons, and how multiple nonprofit organizations can be directly and indirectly related to one another.

c) **Have taxpayers expressed concerns to the IRS regarding the compliance burden associated with the redesigned Form 990? If so, describe the primary compliance issues identified by taxpayers and what the IRS has done, or plans to do, to address taxpayer concerns.**

The IRS extensively redesigned Form 990 for tax year 2008 to promote tax compliance and increase transparency. The redesign was a comprehensive, collaborative process that included meetings with taxpayer groups and feedback from the EO sector (including the public, state charity regulators, the media, and policymakers) during conferences and speeches. Also, based on feedback from the over 800 formal public comments on drafts of the 2008 Form 990, schedules, and instructions, the IRS recognized that the transition from the old to the redesigned Form 990 would change the way some organizations capture and track data for them to complete the Form.

Thus, to help all filers become familiar with the Form, we released two drafts of the 2008 Form 990 in the year and a half prior to publication of the final Form, along with multiple educational resources on how the Form had changed and tips for completing it. To give small and mid-sized organizations with fewer legal, accounting, and administrative resources more time to adapt to the reporting transitions, we also implemented a 3-year phase-in period, raising the asset and gross receipts thresholds for Form 990 filing by ten-fold (from $100,000 in gross receipts and $250,000 in assets to $1 million and $2.5 million, respectively) for tax year 2008, by five-fold for tax year 2009 ($500,000 and $1.25 million), and ending at $200,000 and $500,000 for tax years 2010 and later. The transition period allowed hundreds of thousands of smaller and mid-sized organizations that would have been required to file the Form 990 for tax years 2008 and 2009 to file the shorter Form 990-EZ for one or both of those years. This transition period also gave organizations time to progressively enable their internal systems to respond to the new requirements.

The major redesign of the Form 990 is complete. The IRS redesigned the Form to make it more streamlined and better organized. We eliminated unstructured attachments, replacing them with structured schedules to promote uniformity and reduce ambiguity over how to report supplemental information. We also added many tools to the instructions, including a Glossary, Appendices, examples and illustrations, and a sequencing list, to help filers complete the Form more easily.

The IRS continues to refine the Form, schedules, and instructions based on public comment. We have made clarifications, corrected errors, and added examples to make the Form easier to understand and complete. As recently as June 2, 2011, we requested public comment on 11 transitional issues and frequently asked questions involving the redesigned Form 990 in Announcement 2011-36. We have received just over 100 comments in response to Announcement 2011-36, which we are in the process of analyzing. Any changes in response to the comments will be made as appropriate. We will do so on an ongoing basis to minimize any potential burdens where consistent with our objectives to increase compliance and transparency.

In response to the Affordable Care Act (ACA), the IRS added a new Part V, Section B to the 2010 Form 990, Schedule H (Hospitals) to gather information related to new requirements for tax-exempt hospital facilities and to related policies and practices. Further, in response to meetings with EO stakeholders that more time was needed for the hospital community to familiarize itself with the new questions and to adjust their systems to gather the information needed as well as public comments on ambiguities in the questions, the IRS issued Announcement 2011-37 that made the entire Part V, Section B optional for the 2010 tax year. The IRS continues to solicit and review public comments on Schedule H revisions and implementation of the ACA requirements for tax-exempt hospitals.

We have posted on our website, IRS.gov/eo, many audio, visual, and written tools to assist filers in understanding and completing the Form 990 and schedules. We also speak at dozens of conferences, seminars, and webinars throughout the year to reach thousands of representatives of tax-exempt organizations and answer their questions about Form 990 preparation. We will also continue to accept comments through the IRS Form 990 comment mailbox.

d) **Is the IRS contemplating any additional changes to Form 990 to further compliance goals? If so, describe the planned modifications and their estimated effect on compliance.**

While the major redesign is complete, we continue to refine the Form 990, schedules, and instructions in response to public comment received informally and through our comment mailbox and request for clarification. See response to question 2(c), above, for a description of the IRS's ongoing efforts to solicit and respond to public comment on the Form 990. In addition, the IRS Exempt Organizations (EO) division seeks and coordinates input from its various operating units, including EO Rulings and Agreements, EO Examinations, and EO Determinations in considering changes to the Form 990, schedules, and instructions. EO also consults with its Chief Counsel's office in considering and drafting such changes.

e) **How is the IRS using the related organization information from the Schedule R? What type of compliance problems is this schedule designed to curb? Is the information reported on the Schedule helpful in improving compliance? If not, are further changes to the schedule contemplated? If so, please describe the planned modifications and their estimated effect on compliance.**

The redesigned Form 990 for tax years beginning in 2008 provides more comprehensive information about an organization than the prior Form 990 in all areas, including the organization's activities, the compensation of its officers and key employees, and relationships with other entities. For instance, the Schedule R is designed to increase transparency by providing a more complete picture of the filing organization's structure, relationships with related organizations, types of transactions with related organizations, and involvement in joint ventures with non-exempt entities.

This disclosure also serves our compliance purposes, as it may suggest potential inurement, private benefit, or non-exempt activity.

We are using this new information, including information on the related organizations reported in Schedule R, to design adaptable risk models to allow us to identify organizations with higher potential for noncompliance. We plan to use these tools to identify organizations that we may contact through specific compliance projects and through our regular examination program. For instance, we may look at compensation from related organizations as part of our determination whether the compensation of certain officers, directors, and key employees is reasonable.

No changes to the Schedule R are presently underway, but we may make modifications to the Schedule R and/or instructions based on comments submitted in response to Announcement 2011-36.

f) **Has the IRS identified any specific governance issues based on the additional information provided on the redesigned Form 990? If so, provide a detailed description of the new issues identified.**

Based on feedback from the regulated community, we have learned that exempt organizations' governing boards have become more involved in Form 990 preparation and review since the Form 990 was redesigned and questions were added in Part VI (Governance) on governance policies and board review of the Form 990. Similarly, we have learned of greater adoption of sound risk management policies by exempt organizations' governing boards in response to Part VI questions.

We also have learned that governing boards of exempt organizations are making greater efforts to add independent board members, and to more carefully scrutinize transactions with board members to ensure that such transactions do not compromise their independence.

In 2010, we initiated a long-term study on the intersection of governance practices and tax compliance. To gather data, we began using a checksheet, enclosed as Exhibit 2(f)-1, at the end of every examination of a return associated with a section 501(c)(3) organization. We are using the checksheet data to better understand how the composition of governing bodies and general governance practices impact tax compliance. In addition, we are using responses to Form 990 to continue developing and testing risk models to improve our examination case selection process. As we compile sufficient information, we plan to work with our research function to analyze long-term data and publicly report the findings.

g) **The IRS recently revoked the tax-exempt status of thousands of organizations across the country for failure to file tax returns as part of the automatic revocation program.**

i) **What is the current status of this program?**

Pursuant to the Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780, section 1223 (2006) (Pension Protection Act), the IRS is implementing the revocation, which occurs by operation of law, of the tax-exempt status of any organization that fails to file a required annual return or Form 990-N e-Postcard for three consecutive years.

In June 2011, the IRS first sent notices to and published the names of approximately 275,000 organizations whose tax-exempt status was automatically revoked because they did not file legally required annual reports for three consecutive years. The IRS believes the vast majority of these organizations are defunct, but also announced special steps to help any existing organizations to apply for reinstatement of their tax-exempt status. As of October 7, 2011, around 385,000 organizations have been automatically revoked. As of October 14, 2011, about 6,500 organizations have applied for reinstatement.

The IRS continues to send notices, reminding organizations of their filing requirements, and publishes the names of additional organizations whose exempt status has been automatically revoked every month. The IRS already is processing applications from those organizations that request reinstatement of their tax-exempt status (the only administrative remedy allowed under section 6033(j)(2)). The IRS recognizes that many small organizations were disproportionately affected by the law change, and is administering a transition relief program for certain small tax-exempt organizations that were made subject to the new Form 990-N e-Postcard filing requirement by the Pension Protection Act. The organizations eligible for the transition relief program pay a reduced user fee with their application. If the application is approved for meeting the requirements for exemption, they automatically regain their tax-exempt status retroactive to the date of revocation.

ii) **How many taxpayers reinstated their tax-exempt status using the procedures in Revenue Procedures 2011-8, 2011-36, and 2011-43?**

iii) **How many taxpayers are currently in the process of being reinstated?**

On June 8, 2011, the same day we published the first Auto-Revocation List (List) on IRS.gov, we also published several pieces of guidance to provide organizations on the List with information regarding reinstatement of their tax-exempt status. Transition relief was offered to certain small organizations under Notice 2011-43. The transition relief included a reduced user fee offered in Rev. Proc. 2011-36 and, if the organization's application for exemption was approved, retroactive reinstatement. All other organizations on the List that applied for reinstatement of tax-exempt status are required to pay the user fee provided in Rev. Proc. 2011-8.

In response to questions 2(g)(ii) and (iii) above, as of October 14, 2011, the IRS has received about 5,500 applications seeking reinstatement and closed about 2,000 (includes approvals and a small number of applications that were withdrawn or closed for failure to provide information substantiating exemption). About 1,550 of the applications were approved for reinstatement under the transition relief provided in Notice 2011-43 (and Rev. Proc. 2011-36), and the remainder came in with the regular user fees provided in Rev. Proc. 2011-8.

iv) What is the average length of time for the processing of a reinstatement request?

We do not track reinstatement requests separately from other requests for determinations. The average length of time for processing all types of EO Determinations cases was 104 days for FY 2011.

v) Is the IRS planning to issue any further guidance related to the automatic revocation program?

The IRS continues to send notices to organizations to remind them of their filing responsibilities. In addition, the IRS continues to update its customer outreach and educational materials to offer ongoing informal guidance and address new issues relating to the automatic revocation program, such as updating applicable FAQs on the IRS website (www.irs.gov).

3) Unrelated Business Income

a) In 2009, the Congressional Research Service estimated that revenues from tax-exempt organizations were $1.4 trillion and the value of assets held by tax-exempt organizations totaled $2.6 trillion.[2] Provide IRS data regarding the revenue and assets of tax-exempt organizations for 2008, 2009, and 2010.

The SOI Division publishes the balance sheet and income statement items for sections 501(c)(3)-(9) tax-exempt organizations only, based on information received on Forms 990 and 990-EZ. The most recent SOI data is from tax year 2008. All figures are based on statistically valid samples, and money amounts are in thousands of dollars. Enclosed as Exhibits 3(a)-1 and 3(a)-2 are Table 3: Form 990-Returns of 501(c)(3-(9) Organizations: Balance Sheet and Income Statement Items, by Code Section, Tax Year 2008, and Table 4: Form 990-EZ Returns of 501(c)(3)-(9) Organizations: Selected Items, by Code Section, Tax Year 2008.

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[2] See *An Overview of the Nonprofit and Charitable Sector*, Congressional Research Service (Nov. 17, 2009).

b) **How does the IRS identify unrelated business taxable income issues for audit? Provide a breakdown of the total number of tax-exempt audits opened by the IRS in 2009 and 2010 that involved unrelated business taxable income issues.**

The IRS identifies unrelated business taxable income (UBTI) issues for audit in two main ways:

- By using Form 990 data to develop data analytics and risk models from the reported information, including unrelated business income; and
- Through the strategic planning working group, which looks at data analytics trends in exam and applications for exemption, newspaper articles, websites, and other public information to identify potential areas of noncompliance and develops projects to address such noncompliance.

As of October 19, 2011, our systems show 874 closed returns with at least one UBTI PIC code for FY 2009, and 1,028 returns had at least one UBTI PIC code for FY 2010. Limitations in PIC code data are discussed in the response to question 1(c). See enclosed Exhibit 1(c)-2, which contains a list of all the Principal Issue Codes (PIC codes) used for closed examinations to identify issues involving tax-exempt organizations for fiscal years 2008 – 2011.

c) **Provide the following figures concerning all 501(c) organizations for the 2009 and 2010 tax year, identifying each type separately.**

i) **How many organizations reported unrelated business taxable income and income exempt from the unrelated business income tax?**

ii) **How many organizations reported both unrelated business taxable and income exempt from the unrelated business income tax?**

In response to questions 3(c)(i) and (ii) above, the SOI Division publishes information on unrelated business income attributed to tax-exempt organizations based on information received on Form 990-T. The most recent SOI data is from tax year 2008. The information requested is shown on SOI Table 1: Number of Returns, Gross Unrelated Business Income (UBI), Total Deductions, Unrelated Business Taxable Income (Less Deficit), Unrelated Business Taxable Income, and Total Tax, by Type of Tax-Exempt Organization, Tax Year 2008, and is enclosed as Exhibit 3(c)(i)-1.

iii) **What is the total amount of tax-exempt royalty income, and tax-exempt rental income reported? What is the average amount of those sources of income among the entities that reported receiving at least some such income?**

Although not published in an annual SOI table or IRS Data Book, SOI does track information relating to royalty income reported on Form 990 and rental income reported

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In response to questions 3(c)(i) and (ii) above, the SOI Division publishes information on unrelated business income attributed to tax-exempt organizations based on information received on Form 990-T. The most recent SOI data is from tax year 2008. The information requested is shown on SOI Table 1: Number of Returns, Gross Unrelated Business Income (UBI), Total Deductions, Unrelated Business Taxable Income (Less Deficit), Unrelated Business Taxable Income, and Total Tax, by Type of Tax-Exempt Organization, Tax Year 2008, and is enclosed as Exhibit 3(c)(i)-1.

iii) **What is the total amount of tax-exempt royalty income, and tax-exempt rental income reported? What is the average amount of those sources of income among the entities that reported receiving at least some such income?**

Although not published in an annual SOI table or IRS Data Book, SOI does track information relating to royalty income reported on Form 990 and rental income reported

on Form 990 and Form 990-EZ. Please note that Form 990-EZ does not ask for information on royalty income. Attached as Exhibit 3(c)(iii)-1 is the following SOI data: Royalty Income Reported by 501(c)(3)-(9) Organizations on Form 990, Tax Year 2008, and Net Rental Income Reported by 501(c)(3)-(9) Organizations on Forms 990 and 990-PF, Tax Year 2008.

iv) What are the most common tax-exempt organization errors related to reporting trade or business income?

As noted in the response to question 1(c), PIC codes are used to provide historical data to create a model to distinguish compliant from non-compliant returns. The specific PIC codes that relate to UBTI are listed in the order of frequency on the enclosed Exhibit 1(c)-2, which lists all used PIC codes for closed examinations involving tax-exempt organizations for fiscal years 2008 – 2011. The specific PIC codes that describe UBTI issues are:

* 33: Unrelated Trade of Business (Other)
* 35: UBI – Expense Allocation Issues
* 36: UBI – NOL Adjustment
* 37: UBI – Income from Controlled Corp. under IRC 512(b)(13)
* 38: UBI – Other

v) Describe IRS procedures for reviewing returns by tax-exempt organizations that report unrelated business taxable income.

When agents are assigned any return for a full-scope audit, they look at all issues on the return, including unrelated business taxable income (UBTI). The Internal Revenue Manual contains procedures for conducting examinations involving UBTI issues. See, e.g., IRM 4.76.2.8, enclosed as Exhibit 3(c)(v)-1.

4) Audits

a) What percentage of the Tax Exempt and Government Entities Division's budget is allocated towards audits and examinations?

Pursuant to clarification from Legislative Affairs that the question is intended to reflect only the EO budget in FY 2011, 60.27 percent of EO's budget is allocated towards audits and examinations.

b) Explain how the IRS reviews allegations of excessive political campaign activity by tax-exempt organizations.

All referrals from whatever source that alleges that a tax-exempt organization is in potential noncompliance with the tax law, including political campaign intervention, are sent to EO Examinations' Classification in Dallas, Texas. Classification staff reviews each allegation to determine whether the referral falls under EO Examination's

jurisdiction. If it does, Classification staff initiates "case building", which includes pulling transcripts of Form 990 and performing other research as appropriate to allow the IRS to make a decision based on a "reasonable belief standard" that further action is warranted. If it is not an EO case, the referral is forwarded to the appropriate IRS Operating Division to be worked through their referral process.

All EO Examination referrals are entered into a database for tracking purposes. Not all referrals entered into the database will be selected for examination.

Procedures exist to ensure that no single individual makes case selection determinations when sensitive issues are potentially involved. All referrals involving political activities are sent to an EO referral committee made up of experienced, career civil servant Exam managers. If the referral committee determines that there is examination potential, the referral is assigned to a field group. When a referral is received by a field group for examination, the Group Manager generally reviews the case and assigns it to an agent with the appropriate level of experience.

c) **What issues does the IRS prioritize when conducting audits of tax-exempt organizations, or reviewing the returns of such organizations?**

Our strategic planning process influences how we focus our Examination resources. The process includes reviewing Form 990 data, Exam trending data, Determinations trending data, input from other IRS functional areas, referrals from the public, news media, and other public information. As also described in the response to question 3(b), our strategic planning working group uses data from the Form 990 returns to review data analytics trends and develop risk models to identify potential areas of noncompliance. This allows the IRS to determine how to allocate resources and to develop projects that focus on areas where we see a need to gather more information. This also allows us to determine types of outreach warranted to assist tax-exempt organizations in their compliance efforts. Enclosed as Exhibit 4(c)-1 is a copy of the most recently published EO workplan (FY 2011), which lists some of the projects initiated through our strategic planning working group.

d) **The redesigned Form 990 requires additional information on related and subsidiary organizations. Has the new information prompted an audit or been of assistance during the course of an audit? If so, please describe the manner in which the information has been used.**

See the response to question 2(e) regarding related organization information.

5) **Current Tax-Exempt Enforcement Initiatives**

a) **In addition to the Hospitals and Universities projects (referenced in sections (c) and (d)), are there any tax-exempt compliance projects that the IRS is currently undertaking? Does the IRS have plans to launch any such**

projects in the upcoming year? If so, please describe the anticipated compliance project.

Each year the EO Division puts out its workplan that includes accomplishments from the previous fiscal year and compliance priorities for the upcoming fiscal year, and also provides updated statistics. Enclosed as Exhibit 4(c)-1 is a copy of the most recently published EO workplan (FY 2011). Some of the workplan highlights include the following:

- Filing demographics and statistical information on the redesigned 2008 Form 990
- Implementation of the ACA legislation
- Colleges and Universities study and related examinations project that asked questions relating to their executive compensation, endowments, and unrelated business income
- International-focused tax enforcement efforts, such as the Gifts-in-Kind examination project, that explore whether charitable assets of exempt organizations are being diverted internationally for non-charitable purposes
- Non-filer Initiatives to help taxpayers comply with their voluntary filing obligations and to improve enforcement

b) Excise Taxes/Penalties

i) How many disqualified persons or organization managers were subject to penalties under IRC § 4958 for violating the excess benefit rules between 2006 and 2010?

ii) How many donor advised funds or supporting organizations were subject to the excess benefit rules of IRC § 4958 between 2006 and 2010? Have any of these organizations lost their tax-exempt status?

iii) How many tax-exempt organizations have been subject to the excise tax under IRC § 4911 between 2006 and 2010 for failure to comply with the lobbying rules?

In response to questions 5(b)(i) – (iii) above, all supporting organizations and donor advised funds, as well as any disqualified persons and organization managers, are subject to the various rules and applicable excise taxes under Chapter 41 (including section 4911) and Chapter 42 (including section 4958).

Our automated examinations systems track excise tax returns of organizations or individuals who were found to have violated Chapters 41 or 42 filed as a result of examinations. However, our examinations systems only capture the aggregate of Chapter 41 and Chapter 42 excise tax assessments and do not separately break down the different types of excise taxes described within the subsections of Chapter 41 and Chapter 42. Thus, our automated examinations system does not separately track or report sections 4911 or 4958 assessment data.

In addition to Examination data, the SOI Division analyzes data from estimates based on statistically valid samples of excise tax returns (Forms 4720) filed voluntarily, not as a result of an examination. Although the SOI Division provides some data on Chapters 41 and 42 excise taxes, they also do not differentiate or separate the data further among the various types of taxes within each chapter. The SOI estimates, based on self-initiated Forms 4720 filed during a particular calendar year, may include Chapter 41 or Chapter 42 violations occurring in various tax years.

Enclosed as Exhibit 5(b)1 – 5 is SOI Table 1: Excise Taxes Reported by Charities, Private Foundations, and Split-Interest Trusts of Form 4720 for calendar years 2006 – 2010. During this time period, SOI estimates that Form 4720 filers self-assessed approximately $1,440,203 in section 4911 excise taxes and $1,322,811 in section 4958 excise taxes.

iv) How many tax-exempt organizations has the IRS found to be engaged in tax shelter transactions between 2006 and 2010? Provide a breakdown of the type of transaction and the results of the audit/investigation.

The IRS Office of Tax Shelter Analysis (OTSA) captures TE/GE-wide information on tax shelter activities that are subject to the disclosure requirements under section 6011 and section 6033.

Pursuant to Treasury Regulations section 1.6011-4, a taxable party that has participated in a listed transaction must file a Form 8886 to meet its disclosure requirements. OTSA data shows 68 Listed Transaction Form 8886 Disclosures from 2006 – 2010. The following table summarizes the number of disclosures by shelter type. OTSA's database does not track the results of the audit/examinations.

Description of Listed Transaction	# of TE/GE Disclosures
IRC 419A(f)(6) - Multi Employer Welfare Plans	6
Intermediary Transactions	5
Contingent Liabilities	*
Roth IRAs	26
IRC 412(i) - Retirement Plans	8
SC2 - S-Corp Stock Transaction	15
IRC 419A – Abusive Trust using Life Insurance Plans	6
Notional Principal Contracts/Swaps	*
Total	68

* 3 or fewer

Also, pursuant to Treas. Reg. section 1.6033-5, certain tax-exempt entities that are subject to section 4965 taxes are required to file Form 8886-T, Disclosure by Tax-

Exempt Entity Regarding Prohibited Tax Shelter Transaction, to disclose information with respect to each prohibited tax shelter transaction to which the entity is a party. OTSA data shows 42 Listed Transaction Form 8886-T Disclosures from 2006 – 2010. The following table summarizes the number of disclosures by shelter type. OTSA's database does not track the results of the audit/examinations.

Description of Listed Transaction	# of TE/GE Disclosures
VEBA Welfare Benefit Fund - 419A(f)(5)	*
Retirement Plans - 412(i)	*
Notional Principal Contracts and Swaps	34
Abusive Trusts providing welfare benefits	4
Unknown	*
Total	42

* 3 or lower

Further, beginning in 2008, the redesigned Form 990 expands the questions relating to tax shelter reporting. The Form asks whether an organization was a party to or were notified by a taxable entity that they were a party to a prohibited party transaction, and whether Form 8886-T was filed, unlike in previous years. In tax year 2008, 87 organizations indicated they were a party to or were notified by a taxable entity that they were a party to a prohibited party transaction on their Form 990. Of these 87 organizations, 28 reported filing a Form 8886-T.

c) **Hospitals**

i) **Describe the IRS's current plans to comply with the new requirement in IRC § 4959 to review, at least once every three years, the community benefit activities of each hospital organization that is subject to the requirements under IRC § 501(r).**

The IRS formed and trained a dedicated group to conduct the community benefit activities review of each hospital organization that is subject to the requirements under section 501(r). This group was formed in October 2010, and reviews started in March 2011. Approximately one third of the required hospital reviews will be conducted each year.

ii) **What steps are the IRS taking to comply with the requirement under IRC § 9007(e) of Pub. L. 111-148, Patient Protection and Affordable Care Act, to submit an annual report to Congress, including the Ways and Means Committee, regarding the level of charity care provided by all hospitals (taxable, charitable, and government)?**

The IRS is coordinating with the Department of Treasury (Treasury) and Health and Human Services (HHS) to develop and gather the information necessary for the report

required under section 9007(e). We are also working with Treasury and HHS on the format of the report as the data becomes available.

d) Universities

i) **On May 7, 2010, the IRS issued its interim report on the colleges and universities compliance project. What is the status of the final report and when does the IRS anticipate completing the final report?**

In September 2008, we sent 400 questionnaires to public and private four-year colleges and universities asking about their unrelated business income, endowments and executive compensation practices. The goal of this project is to gain a better understanding of one of the largest, most complex segments in our sector and identify issues and areas that may need more outreach and education or further scrutiny. We analyzed the responses and issued an interim report in May 2010. The interim report contained preliminary information on the respondents' organizational structures, demographics, exempt and unrelated business activities, endowments, executive compensation and governance practices. Because we divided the college and university sector into small, medium and large entities based upon student population when selecting the sample to receive the questionnaire, the interim report provides information based upon that breakdown. For the final report, we are continuing to analyze the responses to the questionnaires, including appropriately weighting the responses from the small, medium and large entities to reflect the sector as a whole. The final report also will provide information concerning the examinations conducted as part of the project, some of which are still ongoing.

ii) **Based on college and university responses to the compliance project questionnaire, the IRS has initiated audits looking at a number of issues, including excessive compensation and unrelated business income.**

(1) **Provide a detailed explanation of how the IRS is identifying and selecting issues for audit as part of the college and university compliance project.**

(2) **List all issues the IRS has identified for audit related to the college and university compliance project.**

As part of the project, over 30 entities were selected for examination based on the responses to the questionnaires and information on the Form 990 and Form 990-T. The examinations are designed to focus principally on unrelated business taxable income (including expense allocation, losses, and debt-financed property issues) and executive compensation issues (including the use of the rebuttable presumption procedure, the initial contract exception, and comparability data by private colleges and universities). Some entities were selected based on potential unrelated business taxable income issues and some were selected based on potential executive compensation issues, but

all examinations looked at both issues regardless of why the entity was selected. As noted, many of these examinations are still ongoing and we will be reporting our findings in the final report.

I hope this information is helpful. If you have any questions, please contact me or have your staff contact Mary Jo Salins at (202) 283-8791.

Sincerely,

Joseph H. Grant
Acting Commissioner
Tax Exempt & Government Entities

Enclosures