

**WRITTEN TESTIMONY OF
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INTERNAL REVENUE SERVICE
BEFORE THE
HOUSE WAYS AND MEANS COMMITTEE
SUBCOMMITTEE ON OVERSIGHT
ON IRS EXEMPT ORGANIZATIONS: CURRENT PRACTICES
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INTRODUCTION

Chairman Boustany, Ranking Member Lewis and Members of the Subcommittee, thank you for the opportunity to appear before you today to discuss current practices and procedures of the IRS Exempt Organizations division (EO).

The IRS has been moving aggressively to implement the robust action plan outlined in my 30-Day Report¹ to restore public confidence in and strengthen the IRS. The first step has been to correct the problems with the 501(c)(4) application process that were described in a report issued in May by the Treasury Inspector General for Tax Administration (TIGTA). Through this action plan we are making improvements throughout the exempt organizations area, as well as undertaking a major effort to examine other aspects of IRS operations to minimize future risks to the tax system.

The significant progress we have made has been fostered by the new leadership installed within EO and also in the top echelons of the agency. This new leadership team blends management experts from outside the agency with long-time IRS leaders from other divisions who have proven track records in their areas of expertise. This has allowed us to synthesize best practices across the IRS to help us drive improvements within EO. Our progress is also a testament to the dedication and commitment of the employees within our Determinations unit and throughout EO.

The last few months have been extraordinarily active ones, and I am pleased to report that we are seeing results from our efforts to chart a path forward for the IRS. The 30-Day Report contains more than 60 action items that we are carrying out through a robust project management plan coordinated by the Commissioner's office. These 60-plus items, which encompass the nine recommendations included in TIGTA's May report as well as the additional actions we are taking, fall into the following categories:

- **Improved screening methods.** After suspending the “be on the lookout” (BOLO) lists in June, we have issued guidelines and instructions to EO personnel requiring that screening assessments be based on activity alone, not names or labels.
- **Checks and balances on information requests.** Managers are now required to review information requests for all cases requiring full review, in which additional

¹*Charting a Path Forward at the IRS: Initial Assessment and Plan of Action*, June 24, 2013, www.irs.gov

detailed information is needed before a determination about an application can be made. Standardized language for questions and letter templates are being developed to reduce burden on applicants. We will incorporate these templates and other instructions being issued to EO personnel into broader IRS guidelines, issued in the form of updated Internal Revenue Manuals (IRMs).

- **Enhanced training.** We have issued verbal and written instructions to managers and screeners on the proper ways to review applications to determine the extent of political campaign activity. Formalized training segments, which address several TIGTA recommendations, are being developed and will be delivered in the near future following the time frames in the report.
- **Reducing inventory of 501(c)(4) applications.** As of last week we had closed 91 of the 132 cases in the “priority backlog” – those which had been pending for more than 120 days as of late May. Of those 91 closures, 70 applications received a favorable determination, eight were withdrawn and 13 were not approved because the organization failed to respond to correspondence. Of the 70 favorable determinations, 36 were the result of the new self-certification option. The other backlog cases remain in process.
- **Streamlining the application process for 501(c)(3) status.** We are developing ways to help reduce a growing inventory in 501(c)(3) applications. An interactive online application is in development, and research is underway to determine the feasibility of a streamlined application process for small organizations.
- **Lean Six Sigma.** EO is taking advantage of Lean Six Sigma methodology² to further improve the determinations process, and also improve workflow.
- **Improved risk mitigation.** We created the new position of Chief Risk Officer, who is establishing the Enterprise Risk Management (ERM) program. This program will enhance the IRS’ ability to manage risks and provide enhanced transparency to critical risks across the agency.
- **Comprehensive review of audit selection criteria.** The new Chief Risk Officer has developed and is implementing a comprehensive plan for review of audit selection criteria in programs throughout the agency.
- **Enhanced awareness of taxpayer rights.** To ensure that taxpayers know their rights and understand what mechanisms exist to help them resolve issues with the IRS, we are committed to initiating internal and external education and outreach about the role of the National Taxpayer Advocate. The Taxpayer Advocate issued a special report to Congress in June, and our offices are working through how best to implement its recommendations.

For each of these areas, my testimony provides further explanation on current procedures, changes that we have initiated and actions that are underway or are planned.

Amid all the efforts the IRS is making to improve operations, we must remain mindful of the responsibility we have to ensure tax compliance. While we work to ensure fairness and efficiency in making determinations about tax exemption, we will continue to uphold

²Lean Six Sigma is a management reengineering methodology widely used in the private sector to improve business performance.

the law as it relates to exempt organizations, and we will continue to meet our obligation to grant tax-exempt status only to those organizations that are fully eligible.

In our efforts to continuously strengthen and improve the IRS, we are also mindful of the need to be transparent and to work closely with Congress. We seek to be as responsive as possible to requests for information from Congressional committees, in order to help them carry out their responsibility to oversee our agency and its operations.

The IRS has, in fact, gone to extraordinary lengths over the last few months to provide information and documents requested by Congress while complying with our legal obligation to keep taxpayer information confidential. This ongoing effort has included:

- The review and production of roughly 390,000 pages of IRS documents in response to requests from this committee;
- Dedicating more than 150 IRS personnel and Chief Counsel attorneys to gathering documents, reviewing them and protecting the taxpayer-specific information in them as required by law;
- Responding to more than 41 different letters from Members of Congress about these issues;
- Answering questions related to the subjects of Congressional investigations at 13 hearings, including the hearing being held today;
- Engaging in hundreds of phone calls and meetings with Congressional staff regarding the production of documents and witnesses; and
- Facilitating 39 interviews of 25 employees by Congressional committees.

We still have a great deal of work to do in setting a course for the IRS, and many challenges remain. But I believe that we are moving in the right direction, and will continue making progress in the weeks and months ahead.

CONFRONTING THE CHALLENGES IN EXEMPT ORGANIZATIONS

Let me turn now to a more detailed discussion of the actions that the IRS has been taking to improve the determination process for applications for tax-exempt status.

The Application Process for Tax-Exempt Status

Our first task in tackling the challenges in Exempt Organizations was to install new leadership to move us forward. In doing so, we have tapped into a broad range of managerial expertise from all corners of the IRS, and from outside the agency as well.

Ken Corbin, whom I appointed as EO acting director, brings with him a wealth of institutional knowledge from our Wage and Investment Division, while Michael Julianelle, whom I asked to serve as acting commissioner of the Tax Exempt and Government Entities Division (TE/GE) brings significant management expertise from various IRS divisions. Heather Maloy, who had been responsible for implementing important management reforms in our Large Business and International Division, has

recently been performing the duties of Deputy Commissioner for Services and Enforcement, and John Dalrymple, who has a long history of managerial experience at the IRS, has just taken over that role in a permanent capacity. Our new Chief Risk Officer, David Fisher, and our chief of staff, Todd Grams, both have brought with them significant external management skills from their long tenures in federal agencies outside the IRS. The combined efforts of this new leadership and our talented and highly skilled work force within EO have allowed us to move forward on a number of fronts in our efforts to correct the problems with the determination process for tax-exempt status.

In addition to installing new leadership, one of our other priorities from the beginning has been to develop guidelines and communicate them to our employees to ensure that they are following proper procedures at every step of the determination process for tax-exempt status. In each of the subject areas below, we have committed to following a three-step process: Developing written guidelines, holding meetings and/or training sessions to communicate this information to employees, and then reinforcing this training by incorporating the information into our formalized instruction, particularly the IRM.

Let me walk the committee through the more significant action items mentioned in the listing above:

Improved screening methods: On June 20, 2013, I suspended the use of any “be on the lookout” (BOLO) lists in the application process for tax-exempt status. The policy in our initial memo on the BOLO list suspension was reiterated in a second memo from the Acting Director, EO Rulings and Agreements, to senior managers on August 9, 2013. Both memos were given to managers and explained to them, and they then held follow-up meetings with their staff to explain the new process. Under this process, EO screeners look for information affecting the determination of tax-exempt status, including activity tied to political campaign intervention, but the screening is done without regard to specific labels of any kind. In addition, employees are being encouraged to elevate to their manager any concerns or issues they encounter when they initially screen an application. Once a concern is elevated to a manager, the manager will move quickly to consider the issue and give the screener the needed instruction, so that our goals for expedient processing will not be negatively affected.

Increasing checks and balances regarding applications selected for further review: We are working to ensure that case development on applications in need of extensive review is fair and is not overly burdensome to applicants. Initial screenings of applications generally lead to one of three results: No additional information is needed and the application can be approved; a small amount of additional information is needed and the application is put into the “intermediate processing” inventory; or extensive additional information is needed, requiring a “full-development” case to be opened in regard to the application.³ It is this third category – accounting for about one third of the applications we receive – where our focus on improvement lies. As an interim measure,

³Proposed denial of an application occurs after additional information is sought as part of intermediate processing or full development of a case.

we are now requiring managers to review, consistent with appropriate goals for expedient processing times, all information-request letters sent to organizations in the full-development category. Managers have been instructed to ensure that the letters have the appropriate tone, and that organizations are asked only the questions that are relevant for determining their eligibility for tax-exempt status.

To ensure fairness on a more permanent and comprehensive basis, we have taken actions to improve the content of information-request letters in cases requiring full review. Specifically, we are developing standardized questions for particular issues that will make these letters consistent and easier to understand. To further standardize letter language, we are developing several dozen letter templates for employees to use. In addition, we are adding language to full-development letters to tell organizations having difficulty resolving issues with their application to contact the employee's manager, and we are adding language explaining to organizations that they can go to the Taxpayer Advocate Service for help as well.

Enhancements to employee training: We have delivered important information and instructions to employees regarding proper identification of applications that require review of political campaign intervention activities. We are going to formalize these training materials and continue to refine them going forward, providing additional technical instruction consistent with TIGTA recommendations, as appropriate. We plan to use online technology to engage all EO Rulings and Agreements employees involved in the determinations process to reiterate existing instructions and provide information related to the new processes.

Reducing the backlog of applications. We have made significant progress in reducing the inventory of applications for tax-exempt status. The TIGTA audit identified 298 cases that had been set aside for additional review based on potential political campaign intervention. As of last week, the number of cases has increased to a total of 518 cases – from 501(c)(3), 501(c)(4) and other tax-exempt organizations. Of that total, 304, or nearly 59 percent, have been closed.

Within the total of 518 cases, 331 are cases involving applications for tax-exempt status under section 501(c)(4). Of these, 225, or 68 percent, are now closed. In working to reduce this inventory, we have paid particular attention to one subset: 132 501(c)(4) organizations with applications that were more than 120 days old as of the end of May. Of those 132, 91 cases, or 69 percent, have been closed. Of that number, 70 received favorable determination letters. This group of 70 includes 36 organizations that took advantage of the self-certification process described below. The total of 91 closed cases also includes eight that were withdrawn and 13 in which the organization failed to respond to correspondence. The remaining cases are still in process, meaning they are under review and a final determination has not been made.

In addition, we are developing an action plan for additional pending cases not included in the original 501(c)(4) backlog and have realigned staffing resources to application processing.

In June, the IRS initiated a special procedure for groups with applications involving possible political campaign intervention or issue advocacy, if their applications had been pending for more than 120 days as of the end of May. This “safe harbor” option provides these groups an approved determination letter granting them 501(c)(4) status within two weeks if they certify they devote 60 percent or more of both their spending and time on activities that promote social welfare as defined by Section 501(c)(4). At the same time, they must certify that political campaign intervention involves less than 40 percent of both their spending and time.

These thresholds apply for past, current and future years of operations. Solely for the purpose of determining eligibility for the expedited procedure, an organization must count, among other things, any public communication identifying a candidate that occurred within 60 days prior to a general election or 30 days prior to a primary as political campaign intervention.

After reviewing the cases whose applications had been pending for more than 120 days, the IRS mailed *Letter 5228, Application Notification of Expedited 501(c)(4) Option* to qualifying organizations. As noted above, a total of 36 organizations completed the self-certification process outlined in the letter and received a favorable determination letter from the IRS.

Corrective Actions to Respond to TIGTA Recommendations

In regard to the nine recommendations made by TIGTA in its May report, we have completed actions addressing three of them, and are on schedule to complete actions addressing the other six by the deadlines listed in the TIGTA report. We have posted monthly updates on IRS.gov on each of the nine recommendations, in order to ensure transparency and keep the public informed of our progress. Following is the status of each recommendation as of August 24, 2013:

Recommendation 1: Ensure that the memorandum requiring the Director, Rulings and Agreements, to approve all original entries and changes to criteria included on the BOLO listing prior to implementation be formalized in the appropriate IRM. **IRS actions: COMPLETED.** Because the use of the BOLO lists was suspended in June, the memorandum is no longer operational. We have provided instructions to staff on appropriate screening criteria and are now incorporating the instructions into the IRM.

Recommendation 2: Develop procedures to better document the reason(s) applications are chosen for review by the team of specialists (e.g., evidence of specific political intervention in the application file or specific reasons the EO function may have for choosing to review the application further, based on past experience). **IRS actions:** We created a committee to oversee and monitor trends, conduct analyses and make recommendations, and develop a documentation process for the reasons why applications are chosen for further review.

Recommendation 3: Develop training or workshops to be held before each election cycle including, but not limited to, the proper ways to identify applications that require review of political campaign intervention activities. **IRS actions:** Training materials are being developed. Internal virtual learning program applications will be used to schedule and monitor training. Training will be incorporated into the FY 2014 training plan.

Recommendation 4: Develop a process for the EO Determinations Unit to formally request assistance from the Technical Unit and the Guidance Unit. The process should include actions to initiate, track, and monitor requests for assistance to ensure that requests are responded to timely. **IRS actions: COMPLETED.** The new process is documented in written procedures.

Recommendation 5: Develop guidelines for specialists on how to process requests for tax-exempt status involving potentially significant political campaign intervention. These guidelines should also be posted to the Internet to provide transparency to organizations on the application process. **IRS actions:** We have provided verbal and written instructions to determination specialists, and these instructions are being incorporated into our formalized guidance, particularly the IRM.

Recommendation 6: Develop training or workshops to be held before each election cycle including, but not limited to: a) what constitutes political campaign intervention versus general advocacy (including case examples) and b) the ability to refer for follow-up those organizations that may conduct activities in a future year that may cause them to lose their tax-exempt status. **IRS actions:** Training materials are being developed. Internal virtual learning program applications will be used to schedule and monitor training. Training will be incorporated into the FY 2014 training plan.

Recommendation 7: Provide oversight to ensure that potential political cases, some of which have been in process for three years, are approved or denied expeditiously. **IRS actions:** As of August 20, 2013, we will have closed 91 cases in the original priority backlog of 132, or 69 percent. This includes 70 cases that received favorable determination letters, of which 36 applicants participated in the optional expedited process. We have also made significant progress on the inventory beyond the original backlog and have realigned staffing resources to application processing in order to further this progress.

Recommendation 8: Recommend to IRS Chief Counsel and the Department of the Treasury that guidance on how to measure the “primary activity” of section 501(c)(4) social welfare organizations be included for consideration in the Department of the Treasury Priority Guidance Plan. **IRS actions: COMPLETED.** On August 9, 2013, Treasury released the 2013-2014 Priority Guidance Plan, which includes guidance under section 501(c)(4) relating to measurement of an organization's primary activity and whether it is operated primarily for the promotion of social welfare, including guidance relating to political campaign intervention. Treasury and the IRS are working on proposed regulations for public comment.

Recommendation 9: The Director, EO, should develop training or workshops to be held before each election cycle including, but not limited to, what language to use in additional information request letters and what additional information should be requested. **IRS actions:** Training materials are being developed. Internal virtual learning program applications will be used to schedule and monitor training. Training will be incorporated into the FY 2014 training plan.

LOOKING AHEAD: ADDITIONAL ACTIONS TO IMPROVE THE IRS

In addition to the action items mentioned above, the IRS is implementing broader managerial and operational improvements in the determination process for tax-exempt status. We also continue to cast a wider net beyond the challenges posed by the determination process in order to enhance procedures throughout the IRS, and to identify and minimize risks wherever they may occur in our operations. Actions in process include the following:

New servicewide employee training. Amid the challenges confronting the IRS today, we need to be mindful of what our fundamental role is and what the core elements of our Mission statement are, along with our values and our overall responsibilities. Given the high level of commitment and dedication of our workforce, it is clear that the vast majority of our employees have a good understanding of the principles they must follow in carrying out their jobs. But, given our roles as public servants, it is important to routinely remind ourselves about these principles, and the institutional aids and protections that we can use when we are confronted with issues in the course of our work. To this end, we recently designed, and are preparing to deliver, universal, mandatory training on many of these core principles. We call this training “Back To Basics.” It is an online refresher course that emphasizes the critical responsibility that all IRS employees have to serve the public, and the ethics to which we must adhere every day. This training covers what actions employees should take when they observe inappropriate behavior in the workplace, as well as what they should do to address issues and escalate concerns in relation to their jobs. IRS employees are scheduled to receive this training in the first quarter of FY 2014 and all employees must complete it no later than December 31, 2013.

Expeditious processing of future applications for tax-exempt status. EO normally receives a total of more than 60,000 applications per year, including applications for 501(c)(3) and 501(c)(4) status among other types of tax-exempt status. EO Determinations has experienced a significant rise in applications since 2010. This increase was mainly the result of factors involving 501(c)(3) organizations, such as the automatic revocations that occurred under the 2006 Pension Protection Act, and the subsequent requests for reinstatement.⁴ Those requests for reinstatement have boosted the

⁴Under the Pension Protection Act of 2006, tax-exempt organizations that do not file a return for three years automatically lose their tax-exempt status. To date, more than 530,000 organizations have had their tax-exempt status automatically revoked. More than 30,000 groups that were auto-revoked have subsequently reapplied for tax-exempt status.

number of 501(c)(3) applications since FY 2010 by more than 30,000. In fact, this year more than 30 percent of the applications we have received are from organizations seeking reinstatement following automatic revocation. We are working on making the determination process more efficient for 501(c)(3) organizations.

This includes the development of an interactive Form 1023, *Application for Recognition of Exemption under Section 501(c)(3)*, which is designed to be filled out online. Most lines of the form include pop-up boxes which, when a user clicks on a given line, will appear and offer guidance on what information needs to be provided. Members of the public have been encouraged to go to IRS.gov to preview the interactive application and provide feedback to the IRS. The form should result in more complete applications, thus reducing processing time.

We are also examining the feasibility of creating a streamlined application process for certain organizations seeking 501(c)(3) status. This process could potentially be used by small organizations that pose a low risk of noncompliance. As explained below, we are using Lean Six Sigma methodology to determine whether such a process would be workable.

Lean Six Sigma. Further management improvements in the determinations area involve the use of Lean Six Sigma, a quality improvement methodology that has been in wide use in both the public and private sectors. The IRS has for some time made Lean Six Sigma methodology available to operating divisions to analyze and resolve bottlenecks in workflow, and EO began taking advantage of it in June 2013.

Teams of experts from the IRS' Lean Six Sigma Office (LSSO) are working with EO Rulings and Agreements subject matter experts and managers in Washington, D.C. and Cincinnati to identify problem areas and recommend improvements. Their goal is to develop a process to improve the flow of applications, from the time they are received until they are approved or other action is taken on them. Work is also being done to develop a process among technical and guidance experts in Washington that will better coordinate Washington's support of the Determinations Unit in Cincinnati and thus improve workflow.

Our Lean Six Sigma team has identified dozens of opportunities for improvement in the application process. Those opportunities are grouped in three common themes: developing a streamlined application process; making initial determinations more quickly; and mitigating risk by balancing the need for efficiency with the need to ensure compliance with the laws governing exempt organizations.

As part of the effort to streamline the application process for 501(c)(3) status, the group has been conducting research to assess how such a process might work, and determine what types of 501(c)(3) organizations might qualify to use it. They have also come up with a number of nuts-and-bolts solutions to help improve workflow. For example, their recommendations succeeded in streamlining mail delivery and distribution in the EO Determinations office, so that new applications are now routed to the office more quickly. Also as a result of their recommendations, more than 30 clerks were detailed to the TE/GE Processing Correspondence Department to help file, sort and scan backlogged

applications, and the Cincinnati Submission Processing Center was used to assist in closing more than 2,500 requests for entity changes.

Enterprise Risk Management (ERM). The ERM program is one of the most important actions arising from the 30-Day Report. The program is intended to bring greater transparency to risks long before they materialize, thus providing opportunities for employees and management to take appropriate mitigation actions. The stand-up of the program is already underway, beginning to lay the foundation that will serve to raise awareness to the Commissioner on critical enterprise-wide risks, as well as empower all IRS employees with tools and procedures to better enable them to identify, manage and mitigate risks at all levels of the organization. The ERM team has already started discussions across the IRS Senior Leadership Team to gain an understanding of the current risk management capabilities that exist across the Service, as well as to identify opportunities for improvement and standardization in the way risks are evaluated and managed throughout the enterprise. The ERM team has already begun a number of initiatives, including a risk-based review of IRS audit selection criteria, which is described in more detail below.

Comprehensive review of audit selection criteria. At the time of the 30-Day Report, we acknowledged that concerns had been expressed about potential partiality in other areas of the IRS, particularly with respect to the manner in which returns are selected for audit. Even though we have found no evidence of such bias, we felt it was appropriate to initiate a review of our audit selection criteria across our business units. The IRS Chief Risk Officer has prepared a comprehensive plan to perform this review, which is well underway. Actions already completed include overview presentations from each of our Business Operating Division Commissioners on their overall examination programs, as well as the accumulation of standard process flows and narrative descriptions of the manner in which specific criteria are identified, approved, updated, and utilized in day-to-day operations for every examination program across the Service. Those process and narrative templates are currently being reviewed for risk of bias, along with the criteria itself, which is currently being collected for each of these examination programs. When complete, we will make the Chief Risk Officer's findings available to the appropriate stakeholders, including the IRS Oversight Board and the Chairmen of the tax-writing committees in Congress.

Examinations of organizations with possible political campaign activity. As part of our effort to look beyond the EO determinations process and examine and improve other IRS programs, we are evaluating our examination function in the tax-exempt area. Out of more than 7,700 exams opened in the exempt organizations area in FY 2013, 29 involve organizations with potential political campaign activity. In June, the new TE/GE leadership team decided that a review was needed of these processes and procedures. A cross-functional team was assigned to perform the review, and the leadership decided to suspend all examinations involving possible political campaign activity while the review is going on. Currently, TE/GE leadership is evaluating the team's recommendations.

Taxpayer Advocate. The 30-Day report noted that existing mechanisms for resolving taxpayer problems are not well understood by taxpayers and therefore are not being

sufficiently leveraged. The report committed the IRS to initiating additional internal and external education and outreach about the role of the National Taxpayer Advocate in assisting taxpayers in resolving problems with the IRS. The Advocate issued a special report to Congress in late June, and our offices are working through how best to implement or incorporate recommended reforms. Essentially, we need to ensure that taxpayers know their rights and in particular, how to engage the Advocate when they feel they are being treated inappropriately or are encountering excessive bureaucratic obstacles. Therefore, we are working with the National Taxpayer Advocate to evaluate the training provided to all IRS employees in this regard, and we are in the process of developing an action plan to detail the necessary improvements to be made to fill whatever gaps exist in the current processes or in actual behavior.

CONCLUSION

Mr. Chairman, Ranking Member Lewis and members of the Subcommittee, thank you again for the opportunity to discuss current processes and procedures within the IRS' Exempt Organizations Division. We will continue our efforts to ensure that the problems that occurred with regard to the scrutiny of applications for 501(c)(4) status will not recur, and we are committed to doing everything we can, not only to further strengthen the application process, but also to improve IRS operations in general. This concludes my testimony. I would be happy to answer any questions that you may have.