



COMMISSIONER

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

March 30, 2005

The Honorable Charles E. Grassley
Chairman, Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I am pleased to respond to your letter of January 18, 2005, concerning the most significant compliance issues within the responsibility of the Tax Exempt and Government Entities Division (TE/GE) of the Internal Revenue Service (IRS). TE/GE's three major business units – Exempt Organizations (EO), Employee Plans (EP), and Government Entities (GE) – oversee a wide range of taxpayers, from small volunteer community organizations to sovereign Indian tribes to large pension funds. These entities are not subject to Federal income tax, but they nonetheless represent a significant component of tax administration. Approximately three million entities make up this sector of the economy. They control approximately \$8 trillion in assets and pay over \$300 billion in employment tax and employee income tax withholding.

We recognize the significance of this sector for tax administration in the IRS Strategic Plan for 2005 – 2009. The Strategic Plan establishes four key objectives aimed at enhancing the enforcement of the tax law over the next five years. One objective focuses directly on the tax-exempt and government entities sector:

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

This letter will focus on problems with compliance that we are now encountering in this sector. This focus should not overshadow the inspiring work that the tax-exempt community does day-in and day-out, nor should it detract from the fact that the overwhelming majority of tax-exempt entities do their utmost to comply fully with the letter and the spirit of the tax law. However, we must recognize that we are now at an important juncture. We can see that tax abuse is increasingly present in the sector, and we intend 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 this sector.

I know this is a concern that you share, as well, and I want to thank you and your Committee for your leadership in this area. I also want to compliment your staff and the

staff of the Joint Committee on Taxation for their attention to areas under TE/GE jurisdiction.

I also wish to acknowledge the leaders of the tax-exempt sector who are exploring options to address abuses in their community. I particularly salute the Independent Sector, the sponsor of the National Panel on Nonprofits, which recently delivered a thoughtful and constructive report to your Committee. The report declares that the "government should ensure effective enforcement of the law," and it calls for tougher rules for charities and foundations. The report also calls for stronger action by the IRS to hold accountable those charities that fail to provide the public with accurate and timely information about their operations.

Introduction

As you requested, we outline below the top compliance issues that we are encountering in the TE/GE area. Your letter also requests that we provide revenue impacts of the compliance issues we identify. Unfortunately, we have no precise way to gauge the revenue impact of these issues, and will not be able to answer those parts of your request. Moreover, in the tax-exempt area of the Internal Revenue Code (Code), revenue is not the key objective. Instead, we focus on insuring that the tax expenditures associated with this sector of the economy achieve their intended goals. Thus, our list of compliance issues was selected not by reason of revenue impact, but rather on the basis of other factors, such as the nature of the noncompliant behavior, whether the behavior is on the rise, and the corrosive impact of such behavior on voluntary compliance and public trust in nonprofit organizations.

This letter is divided into four parts. First, we outline external factors currently impacting this sector. Second, we list the top compliance problems by function within TE/GE. Third, we outline actions we have taken to address these compliance problems. Finally, we identify unresolved policy issues that should be part of any discussion of reform.

I. External Factors Impacting The Sector – A Less Compliant Environment

A number of factors are impacting compliance in the TE/GE area. As might be expected, these factors do not necessarily operate independently of one another. Nor are they all negative. Taken together, however, they add up to a culture that has become more casual about compliance and less resistant to non-compliance.

Increase in size and complexity of the tax exempt sector. Most parts of the TE/GE sector have grown rapidly over the past decade, and this growth has impacted the manner in which organizations do business. The number of tax exempt organizations on our master-file has increased by almost 500,000 since 1995, to 1.8 million today. In the period from FY 1998 to FY 2002 alone, the reported value of the assets of these organizations grew from approximately \$2 trillion to more than \$3 trillion. While the

number of employee plans has generally remained stable, the reported value of the assets held by those plans has increased by approximately \$2.3 trillion since 1995.

In the tax-exempt bond area, the trend is similar. Debt outstanding has more than doubled since 1995, as has the number of issuances.

With respect to Indian tribal governments, a significant portion of the tribal community has been transformed by the advent of gaming. The number of Indian gaming casinos has more than quadrupled since 1995, to 440, and estimated revenues from these operations have gone up by more than 300 percent, to \$16.7 billion, in the same period.

The lack of an adequate enforcement presence in recent years. In TE/GE, as in the rest of the IRS, our enforcement presence faded in the late 1990s. 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. The enforcement presence also declined in the retirement plan area. In both EO and EP, overall staffing declined and fewer and fewer employees were deployed to do traditional enforcement work. This decline, combined with the significant growth of the tax-exempt sector noted above, created opportunities for noncompliance.

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, some 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.

Arising in part from the same weak governance practices, some parts of TE/GE's 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. TE/GE customers are natural candidates. We are concerned that tax-indifferent parties are being used as accommodation parties to enable abusive tax shelters. Of the 31 categories of listed transactions, nearly half have the potential to involve tax-indifferent parties either as an accommodation party or as a more active participant.

Whether the transaction involves a municipal pension plan or a charity, we believe that the tax-indifferent party that involves itself, or allows itself to be used, may be inappropriately trading on its privileged tax-exempt status. Some shelter promoters use tax-indifferent parties to create abusive shelters where, for a fee, the entity lets the promoter exploit its tax-free status.

Other abusive transactions are less complex, but just as corrosive to the credibility of the tax system and to the public's faith in our tax-exempt 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 deal with the charitable sector. It 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 exempt organization transparency. 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 an 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 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 a number of watchdog groups that monitor charitable organizations. These groups post the information to 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.

II. Top Current Compliance Problems Facing TE/GE

I would like to turn now to the identification of the most significant compliance problems currently facing TE/GE. We will discuss abusive organizations, organizations that are abused by third parties, and other compliance challenges within the TE/GE sector. We will group related abuses and associate them with the function within TE/GE that is primarily responsible for responding to them.¹

¹ Tax issues related to the donor of a charitable contribution, such as deductibility, are generally not within the jurisdiction of TE/GE.

Exempt Organizations

EO-1. Charities established to benefit the donor. As mentioned above, this group of compliance issues shares the same general principle: a donor receives a charitable contribution deduction while maintaining control over the contributed assets, often using them for personal gain. Examples include abusive organizations in the following categories:

Abusive donor-advised fund arrangements. A donor-advised fund is a separate fund or account maintained by a public charity to receive tax-deductible 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 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 Code section 170. Also, they often claim that the assets transferred to the funds may grow tax free and later be used to benefit the donors to reimburse them for their expenses, or to fund their children's educations.

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 one or more other exempt organizations, usually other public charities. The category covers 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 may 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 the "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 a 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.

Corporation sole abuses. 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 may 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 being promoted is that the arrangement entitles the individual to exemption from Federal income taxes as a nonprofit, religious organization described in section 501(c)(3). The position is utterly without merit.

Charitable trust problems and abuses. Some promoters have set up purported charitable or split-interest trusts that can be used for a taxpayer's personal benefit. There are a variety of schemes, all without legal merit, designed to allow individuals to deduct amounts that ultimately will be used for their personal expenses. The trust typically is a nonexempt charitable trust formed under state law 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. Because the trusts are not tax-exempt, they generally do not seek confirmation of their status with the IRS.

We have also seen a variety of abusive promotions involving charitable remainder trusts, which have both charitable and non-charitable elements. One marketed scheme uses these trusts to avoid capital gains on highly appreciated property. The property is transferred to the trust, which sells the property and provides the bulk of the sales proceeds to the transferor relatively quickly, but structures the formal consummation of the sale to occur in a later year when the transferor has little gain to report. The transferor avoids reporting the gain received in the earlier years. 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.

EO-2. Abusive credit counseling organizations. Increasingly, it appears that certain 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.

EO-3. Regulation and reporting of political activity of non-profits. We have seen an apparent increase in the political activity of tax-exempt organizations during the recent election. 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 Congress.

EO-4. Misuse of charities for charitable deductions. The problem in this area often concerns an overstatement by the taxpayer of the value of the donation.

Conservation easements. In recognition of the need to preserve our heritage, the 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.

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 and from aggressive taxpayer positions. Additional enforcement concerns are whether consideration has been received in return, and whether only a partial interest has been transferred.

EO-5. Abusive tax shelters. We are concerned about tax-indifferent parties being used as accommodation parties or otherwise to facilitate abusive tax shelters. An “accommodation party” is a term 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-indifferent parties, including charities and other tax-exempt organizations, private and government retirement plans, Indian tribal governments, and municipal governments, to achieve abusive results.

Almost half of the 31 transactions we have identified to date as listed transactions under the tax shelter disclosure regulations involve the use of a tax-indifferent party. 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.

EO-6. 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 consider excessive 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.

EO-7. Funding of terrorism. We want to ensure that U.S. charities have no role in financing terrorist activity, and we continue to assist, in both the criminal and civil arenas, the fight against terrorism and those who fund it. We have established a number of mechanisms to insure that our Criminal Investigation and EO functions work together on potential cases involving terrorist financing. EO is also working to develop 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.

Employee Plans

EP-1. Abusive retirement vehicles. We have found a number of areas where retirement plans are being promoted for abusive purposes either to shelter income or accelerate deductions.

Certain Roth IRAs. Contributions to a Roth IRA are limited by law. To circumvent these limits, various schemes have been promoted in which taxpayers try to improperly inflate the value of a Roth IRA. A frequent theme is the transfer to the Roth IRA of property at less than fair market value by the Roth IRA owner. For example, a Roth IRA may control a shell corporation that enters into transactions at less than fair market value with an already-existing business of the owner of the Roth IRA. The result of the transactions is a transfer of value from the owner's business into the Roth IRA. Another theme is the transfer of a shell corporation established by the Roth IRA owner to the Roth IRA. The IRA-owned corporation then begins operations and the Roth IRA owner provides services to the business on a below-market basis. The resulting increase in value of the corporation later is distributed tax free.

Abuses using life insurance in qualified plans. Deductions for contributions to qualified retirement plans are limited by law, as are the benefits payable. Employers have attempted to avoid the Code's limitations on deductible contributions to qualified retirement plans and the maximum benefits payable under these plans by contributing excessive amounts to Code section 412(i) plans that are funded exclusively by individual life insurance contracts. The excess contributions and benefits are masked using various strategies. For example, life insurance contracts are purchased on the lives of plan participants and upon termination of the participant's employment or termination of the plan these contracts are distributed to the participants at artificially low values.

S-corporation management ESOPs. In 2001, the Congress enacted legislation, effective in 2005, to limit the tax benefits derived from the ownership of S corporations by Employee Stock Ownership Plans (ESOPs). However, there are arrangements that were created before the effective date of the new law that are abusive and, in addition, violate other provisions of the Code. In these arrangements, taxpayers attempt to exclude the income of an operating business through the use of a combination of an S corporation and an ESOP.

We have found that in many of these arrangements, the ESOP fails to satisfy the requirements of the Code for a valid ESOP.

EP-2. Pension funding. We have found problems in the level of funding of certain defined benefit plans. Weaknesses in the pension funding rules have resulted in serious plan underfunding, and benefit losses to plan participants, and the termination

of underfunded plans has resulted in record deficits for the Pension Benefit Guaranty Corporation (PBGC). Part of the underfunding problem relates to transitions in the economy as it becomes less centered on manufacturing, but part relates to the tax and non-tax funding rules and to limits on their enforcement.

EP-3. Boise Cascade decision. Code section 404(k) allows employers who sponsor ESOPs to deduct dividend payments paid in cash to ESOP participants. Section 404(k) was intended to apply to ordinary dividends paid by the employer on its stock. However, in 2003 the U.S. Court of Appeals for the Ninth Circuit held that Boise Cascade could, in effect, use section 404(k) to deduct payments made to redeem stock when participants in the ESOP terminate employment.

This decision opens the door to potential abuses of ESOPs. It also is directly contrary to Code section 162(k), which disallows deductions for redemptions of stock. Further, Code section 404(k) has no applicability to the redemption of stock on employees' termination of employment. A redemption of stock cannot be considered a dividend when the redemption occurs solely to pay out the terminating employees. Finally, treating such payments as deductible contributions would vitiate important protections for ESOP participants and would duplicate an earlier deduction for the same economic expense because the original contribution of the stock was deductible under Code section 404(a).

Government Entities

GE-1. Pooled financings designed to earn and divert illegal arbitrage. In a pooled financing, a State or local government issues tax-exempt bonds to finance loans to a group of other local governments or charitable organizations. Using pooled financing allows smaller, less creditworthy entities to borrow money at reduced interest rates and spreads the costs of issuance.

There are several abuses, with a common thread of over-issuance of pooled financing obligations and diversion of arbitrage earned. Arbitrage rules require that arbitrage profits be repaid to the U.S. Government in these cases; however, through multiple methods, arbitrage earnings have been diverted and used to fund higher-than-normal issuance costs and profits to transaction participants.

GE-2. Indian tribal government issues. We have found certain compliance issues in the Indian tribal government area. As stated, these arise in the context of the economic development boom enjoyed by some tribes that have entered the gaming industry.

Under the Indian Gaming Regulatory Act, revenues from tribal gaming can be used for several authorized purposes, including funding tribal government operations, providing for the general welfare of the tribe, and making taxable per capita payments to tribal members. Per capita distributions are subject to Federal income tax, and must be reported on Form 1099. In order to reduce the tax consequences to members, certain tribes have created mechanisms to classify payments as general welfare programs,

often through liberal interpretations of what constitutes a “need-based” program, or have created or invested in income deferral programs.

In addition, there has been a significant increase in financial products being offered to tribes and tribal members to shelter gaming distributions from taxation. While some programs may legitimately achieve that goal, we are seeing an increase in abuse of tribal government programs solely to shelter income for members, as well as an increase in aggressive shelter products being marketed to tribes.

Tribes have contacted the IRS on some abusive schemes being promoted directly to them, or being marketed to members.

III. The IRS Response

To address these compliance challenges, to dissuade promoters and others from initiating new ones, and to achieve our key objective of deterring abuse and misuse of tax-exempt and governmental entities, we are revitalizing our enforcement program in the tax-exempt sector, and refocusing the methods we use to identify and examine potentially non-compliant organizations.

Revitalizing Enforcement in the Tax-Exempt Sector. The FY 2004 and 2005 budgets have increased for TE/GE, and especially for the EO function. While the budget for the IRS increased approximately 0.5 percent in FY 2005, TE/GE received an 8 percent increase, EO received a 14 percent increase, and EO examinations received a 21 percent increase. In EO examinations, this increase will translate, by September, into a 30 percent increase in staffing over September 2003.

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 this request, the amount we plan to dedicate to the tax-exempt area would be used to increase vigilance against the misdirection of exempt organization assets for terrorism or private gain, to combat abusive promotions involving TE/GE entities, to start examinations quickly when we detect a risk, and to give agents better information for their first contact with taxpayers.

Refocusing of Efforts – Pursuing the Right Cases. We have translated the increased funding into concrete results in all parts of TE/GE. In FY 2004, we added 70 new agents to conduct EO examinations and 13 additional employees for the new EO Compliance Unit, which reviews Forms 990. The Administration’s FY 2005 budget supports the creation of an EO Financial Investigations Unit. I also reallocated more than \$20 million to TE/GE for FY 2005 to fund, among other things, the following:

- New positions to create an EP Compliance Unit to build off the success enjoyed by the EO Compliance Unit.
- New exam positions for TE/GE’s Federal, State and Local Governments function to pursue Federal agency compliance and to establish a

large-case program in employment tax and withholding for governmental agencies.

- Expanded imaging of EO returns, including all Forms 990 and 8038, to support efforts to clean up the Forms 990, assist in counter-terrorism, and enhance bond enforcement.
- New positions to enhance our compliance presence by expanding the efficient EO Compliance Unit.
- New positions in EO to create a classification unit that will check high-risk organizations' compliance.
- New revenue agent positions to bolster compliance through additional examinations across TE/GE.
- Restoration of funding from other cuts to enforcement expenses.

We are at work on all the compliance problems discussed above. For example, in response to credit counseling abuses, we have over one-half of the industry, measured by gross receipts, under examination, and we have revoked or proposed revocation of exemption for over 20 percent of the industry, also measured by gross receipts. We have worked to ensure that compliance problems involving tax-exempt entities are addressed across all IRS business units. For example, to stop abuse in donor-advised funds, the Small Business/Self-Employed Division of the IRS has more than 200 examinations of donors underway, and TE/GE has revoked the exemption of one entity and proposed the revocation of another.

On the conservation easement matter, we have almost 50 donor audits, several exempt organization audits, and an ongoing pre-audit review of 400 open-space easements, to be followed by a similar review of 700 façade easements.

We are using all enforcement tools available to us, including the pursuit of promoters, the use of referrals to the Office of Professional Responsibility, and criminal prosecution, where appropriate.

IV. IRS Focus Areas for Discussion of Reform – 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 TE/GE 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. For example, 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. There have also 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, retirement plan participants, or bondholders. Moreover, even where we have an intermediate sanction, it may not work as intended.

Similar discussions may be worthwhile with respect to the reporting requirements for political action committees.

With respect to defined benefit plans, the funding rules are based on the assumption that the plans will continue into the future. These rules may result in substantial underfunding of a plan that terminates, even in the case where the sponsor has made all required minimum contributions.

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, the 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 healthcare, 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 the resulting fact-intensive cases.

Finally, the events of September 11 have brought an awareness that some of our ways of doing business need to be re-evaluated to inhibit the designs of those who wish us ill. In our endeavors to ensure that exempt organization funds are not diverted to improper purposes, including terrorism, we do not have tools to sanction public charities that fail

to monitor their grants comparable to the available tools with respect to private foundations. For those organizations that need not file for exempt status and do not file annual returns, such as small organizations 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 as to whether to enhance transparency, and if so, how to proceed. As we noted here 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 (e.g., those exempt organizations that are not required to file a Form 990). 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 990PF. The recent report by the Independent Sector, referenced above, supports mandatory electronic filing of 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 IRS, 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 high enough level 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. I would ask the Committee to support the Administration's 2006 budget proposal, which calls for an 8 percent increase in our enforcement budget.

Thank you for the opportunity to highlight what we believe to be our greatest compliance challenges. We look forward to working with the Committee on problems in the TE/GE-regulated community and exploring ways to better equip the IRS to deal with these problems.

I am sending a similar letter to Senator Baucus. If you have any questions, you may call me or Martha Sullivan, Director, Exempt Organizations at (202) 283-2300.

Sincerely,



Mark W. Everson