



*Statistical Profile of Alleged Political
Intervention by Tax-Exempt Organizations
in the 2004 Election Season*

May 12, 2009

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Redaction Legend:

1 = Tax Return/Return Information



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 12, 2009

MEMORANDUM FOR COMMISSIONER, TAX EXEMPT AND GOVERNMENT ENTITIES
DIVISION

FROM: *Michael R. Phillips*
Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Statistical Profile of Alleged Political Intervention
by Tax-Exempt Organizations in the 2004 Election Season
(Audit # 200810033)

This report presents the results of our statistical profile of alleged political intervention by tax-exempt organizations in the 2004 election season. The overall objective of this review was to provide nationwide statistical information for the 2004 Political Activities Compliance Initiative (hereafter referred to as the Initiative) and determine how the Exempt Organizations function addressed political activity noncompliance. This audit was requested by the United States Senate Committee on Finance and was conducted as part of the Treasury Inspector General for Tax Administration Fiscal Year 2009 Annual Audit Plan under the major management challenge of Tax Compliance Initiatives.

Impact on the Taxpayer

The objective of the 2004 Initiative was to promote compliance with the prohibition against political campaign intervention by reviewing allegations and initiating examinations of political intervention by tax-exempt organizations on an expedited basis. As part of the 2004 Initiative, the Internal Revenue Service (IRS) has completed 107 of 110 examinations and issued letters to the majority of examined tax-exempt organizations warning them of the consequences of future prohibited political activity. However, closing letters sent to tax-exempt organizations did not always state whether the IRS determined the prohibition against political intervention had been violated, which can be confusing for tax-exempt organizations.



Statistical Profile of Alleged Political Intervention by Tax-Exempt Organizations in the 2004 Election Season

Synopsis

For the 2004 Initiative, the IRS opened 110 examinations and we were able to review at least some information for 99 of them. Examinations most often were initiated after referrals were received from sources external to the IRS and were almost evenly distributed between churches and charities. The examinations mainly concerned tax-exempt organizations that had allegedly been involved in a single instance of potentially prohibited political intervention and involved issues/campaigns at the national level slightly more than at the State and local level. In addition, examinations involved a wide array of issues, such as distribution of printed and electronic information, as well as verbal statements and direct political contributions.

Through November 2008, the IRS had completed 107 of the 110 examinations. The majority of the examinations resulted in closing letters issued by the IRS to the tax-exempt organizations, warning them of the consequences of future prohibited political activity. The IRS revoked the tax-exempt status of six organizations as a result of examining the organizations for political campaign intervention. We determined that the facts and circumstances of the cases that involved an organization whose tax-exempt status was revoked were clearly different from those of organizations that received only a warning. At the conclusion of an examination, the IRS can also assess an excise tax; however, this is rare because the circumstances do not always lend themselves to imposing or being able to calculate a tax.

As of November 2008, the IRS' inventory system showed that the IRS had substantiated prohibited political activity in 76 (71 percent) of the 107 examinations it had completed. While reviewing case information, we found that this number was overstated. Based on our review of case files, the IRS incorrectly coded 14 cases as involving violations of the political intervention prohibition when no violations occurred. While the data still shows that a majority of examinations resulted in the IRS determining that tax-exempt organizations had violated the prohibition, it is important that this information be accurate because it is reported to external stakeholders. We determined that the incorrect coding was due to confusion over how to classify case results on the inventory system.

In addition, 15 of the closing letters from the 99 case files we reviewed did not specifically state whether the IRS determined that the prohibition against political intervention had been violated, which can be confusing for tax-exempt organizations that spend resources on a lengthy examination. Closing letters were sometimes silent on whether the prohibition had been violated because of a lack of guidance to ensure that closing letters clearly state whether prohibited political activities occurred.



*Statistical Profile of Alleged Political Intervention by
Tax-Exempt Organizations in the 2004 Election Season*

Recommendation

We recommended that the Director, Exempt Organizations, create and issue guidance to ensure that 1) IRS examiners are guided on the use of the correct disposal code when political intervention is not substantiated and 2) closing letters to tax-exempt organizations clearly state whether a prohibited political activity violation was substantiated.

Response

The Commissioner, Tax Exempt and Government Entities Division, agreed with our findings and assessment of the measurable benefits on tax administration. The Exempt Organizations function has completed corrective actions to address our recommendations by creating and issuing guidance in its Initiative training materials, including providing sample closing letters for use by examiners. IRS examiners are instructed to refer to and comply with this guidance in working Initiative cases. As a check to ensure this guidance is followed, the Initiative Team Leader, using the Initiative training materials, is required to review and approve all closing letters before issuance. As part of this review and approval process, he or she provides the correct disposal code to be used by the examiner and ensures that closing letters to tax-exempt organizations clearly state whether a prohibited political activity violation was substantiated. This guidance is presented during training and is reinforced in regular conference calls with examiners, managers, the Initiative Team Leader, Counsel, and others. Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Nancy A. Nakamura, Assistant Inspector General for Audit (Management Services and Exempt Organizations), at (202) 622-8500.



*Statistical Profile of Alleged Political Intervention by
Tax-Exempt Organizations in the 2004 Election Season*

Table of Contents

Background	Page 1
Results of Review	Page 4
Political Activity Examinations Typically Originated From External Sources and Involved Both Churches and Charities	Page 5
Political Activity Examinations Typically Involved Local Tax-Exempt Organizations Who Allegedly Committed a Single Prohibited Act	Page 6
Political Activity Examinations Involved Tax-Exempt Organizations That Distributed Printed and Electronic Material, As Well As Made Verbal Statements and Campaign Contributions	Page 7
The Majority of Examinations Resulted in Warning Letters Being Sent to Tax-Exempt Organizations	Page 7
A Clear Demarcation Exists Between Organizations Whose Tax-Exempt Status Was Revoked Versus Organizations That Retained Their Tax-Exempt Status.....	Page 8
Excise Taxes on Political Activities Are Difficult to Assess.....	Page 9
Initiative Results Were Misstated	Page 9
<u>Recommendation 1:</u>	Page 10
Closing Letters Issued at the Conclusion of an Examination Were Not Always Clear	Page 10
<u>Recommendation 2:</u>	Page 12
Appendices	
Appendix I – Detailed Objective, Scope, and Methodology	Page 13
Appendix II – Major Contributors to This Report	Page 15
Appendix III – Report Distribution List	Page 16



*Statistical Profile of Alleged Political Intervention by
Tax-Exempt Organizations in the 2004 Election Season*

Appendix IV – Outcome Measures.....Page 17
Appendix V – Management’s Response to the Draft ReportPage 18



*Statistical Profile of Alleged Political Intervention by
Tax-Exempt Organizations in the 2004 Election Season*

Abbreviations

IRS

Internal Revenue Service



*Statistical Profile of Alleged Political Intervention by
Tax-Exempt Organizations in the 2004 Election Season*

Background

Under Internal Revenue Code Section 501(c)(3),¹ charities, educational institutions, and religious organizations, including churches, are exempt from Federal income tax. To qualify for and maintain tax-exempt status, organizations must be organized and operated for their tax-exempt purpose.

While many charities speak out on public issues as an integral part of carrying out their tax-exempt purpose, tax-exempt organizations are prohibited from participating or intervening in any political campaign on behalf of, or in opposition to, any candidate for public office. Charitable, educational, and religious organizations, including churches, cannot endorse candidates, make donations to campaigns, engage in fundraising, distribute statements, or become involved in any other activities that may be beneficial or detrimental to any particular candidate. Activities which encourage people to vote for or against a particular candidate violate the political campaign prohibition.

The prohibition against political activities for charities and churches has existed since the 1954 revision of the Internal Revenue Code. However, in the 2004 election cycle, the Internal Revenue Service (IRS) recognized that referrals of potential political intervention by charities and churches were increasing. In response, the IRS initiated a Political Activities Compliance Initiative (hereafter referred to as the Initiative) in June 2004. The Initiative was part of a multipronged strategy for the Exempt Organizations function to guide, publicize, perform outreach, and accelerate the process of determining whether tax-exempt organizations should be examined. The objective of the Initiative was to promote compliance with the prohibition against political campaign intervention by reviewing allegations and initiating examinations of political intervention by tax-exempt organizations on an expedited basis. Since the 2004 Initiative, the IRS has continued to conduct political activity compliance initiatives during Federal election years.

In November 2004, we initiated a review of the Initiative at the requests of the former IRS Commissioner and the Commissioner, Tax Exempt and Government Entities Division. We reported in February 2005² that the Tax Exempt and Government Entities Division handled referrals of potential political campaign intervention consistently, but the referrals were not always processed in a timely manner. We limited that review to the referrals because some of the referrals had just been assigned for examination at the time of our fieldwork. Subsequently, at the request of the former IRS Commissioner, we reviewed the 2006 Initiative and assessed the

¹ Internal Revenue Code Section 501(c)(3) (2006).

² *Review of the Exempt Organizations Function Process for Reviewing Alleged Political Campaign Intervention by Tax Exempt Organizations* (Reference Number 2005-10-035, dated February 17, 2005).



Statistical Profile of Alleged Political Intervention by Tax-Exempt Organizations in the 2004 Election Season

effectiveness of the Tax Exempt and Government Entities Division in addressing alleged political campaign intervention by tax-exempt organizations and determined whether actions had detected potential repeated campaign intervention by previously identified organizations. We reported that the Exempt Organizations function increased its efforts to educate tax-exempt organizations about prohibited political activities and enhanced several internal processes. However, it could further improve its effectiveness by tracking the reasons that timeliness goals are not always met and by ensuring that all employees clearly understand what should be included in the Initiative.³

Examinations of potentially prohibited political activity originate from referrals that are received from both IRS employees and from external sources. The referrals are evaluated by an independent, experienced group of Exempt Organizations function employees, known as the Referral Committee.⁴ The Committee considers the referral and supporting evidence and decides whether the referral warrants an examination. Upon initiating an examination, the Exempt Organizations Examination function notifies the tax-exempt organization that it will be investigated for potentially prohibited political activity.

As part of our continuing efforts to assess how the IRS addresses tax-exempt organizations that potentially participated in prohibited political activities, we met with the United States Senate Committee on Finance on August 1, 2007. During the meeting, staff members expressed an interest in the scope of violations of the prohibition on political intervention as well as the size of the organizations involved in the 2004 Initiative. They questioned whether the cases reviewed were identified by the IRS or by sources outside the IRS. The staff members also were interested in an assessment on the magnitude of political intervention substantiated through examinations, the egregiousness of the interventions, whether substantiated political intervention involved national or local politics, and the method of intervention.

This review was limited to providing statistical information on the 2004 Initiative and the criteria for determining how the Exempt Organizations function closed examination cases concerning prohibited political activities by tax-exempt organizations. We did not assess actions taken by examiners during their review of tax-exempt organizations or their conclusions as to whether or not tax-exempt organizations participated in prohibited political activities. In addition, our review was limited to information available for our review. The 2004 Initiative consisted of 110 examinations. In November 2008, three examinations from the Initiative remained open and were not available for review. In addition, the IRS could not locate 19 of the closed examination case files at the Ogden Campus, which is where many of the case files were sent after they were

³ *Improvements Have Been Made to Educate Tax-Exempt Organizations and Enforce the Prohibition Against Political Activities, but Further Improvements Are Possible* (Reference Number 2008-10-117, dated June 18, 2008).

⁴ The Referral Committee is comprised of three members who are experienced Exempt Organizations function technical employees (e.g., senior examiners, function specialists, group managers, or area managers). The Committee's responsibility is to consider, in a fair and impartial manner, whether information items referred have examination potential.



*Statistical Profile of Alleged Political Intervention by
Tax-Exempt Organizations in the 2004 Election Season*

closed. However, the IRS was able to provide some information for 11 of the 19 missing cases. When possible, we used this information in our analyses, which enabled us to review at least some information from a total of 99 examinations performed in the 2004 Initiative.

This review was performed at the Exempt Organizations function Examinations office in Dallas, Texas, during the period April through December 2008. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



Statistical Profile of Alleged Political Intervention by Tax-Exempt Organizations in the 2004 Election Season

Results of Review

For the 2004 Initiative, the IRS opened 110 examinations and we were able to review at least some information for 99 of them. Examinations most often were initiated after referrals were received from sources external to the IRS and were almost evenly distributed between churches and charities. The examinations mainly concerned tax-exempt organizations that had allegedly been involved in a single instance of potentially prohibited political intervention and involved issues/campaigns at the national level slightly more than at the State and local level. In addition, examinations involved a wide array of issues, such as distribution of printed and electronic information, as well as verbal statements and direct political contributions.

Through November 2008, the IRS had completed 107 of the 110 examinations. The majority of the examinations resulted in closing letters issued by the IRS to the tax-exempt organizations, warning them of the consequences of future prohibited political activity. The IRS revoked the tax-exempt status of six⁵ organizations as a result of examining the organizations for political campaign intervention. We determined that the facts and circumstances of the cases that involved an organization whose tax-exempt status was revoked were clearly different from those of organizations who received only a warning. At the conclusion of an examination, the IRS can also assess an excise tax; however, this is rare because the circumstances do not always lend themselves to imposing or being able to calculate a tax.

As of November 2008, the IRS' inventory system showed that the IRS had substantiated prohibited political activity in 76 (71 percent) of the 107 examinations it had completed. While reviewing case information, we found that this number was overstated. Based on our review of case files, the IRS incorrectly coded 14 cases as involving violations of the political intervention prohibition when no violations occurred. While the data still shows that a majority of examinations resulted in the IRS determining that tax-exempt organizations had violated the prohibition, it is important that this information be accurate because it is reported to external stakeholders. We determined that the incorrect coding was due to confusion over how to classify case results on the inventory system.

In addition, we determined that 15 of the closing letters from the 99 case files we reviewed did not specifically state whether the IRS determined that the prohibition against political intervention had been violated, which can be confusing for tax-exempt organizations that spend resources on a lengthy examination. Closing letters were sometimes silent on whether the prohibition had been violated because of a lack of guidance to ensure that closing letters clearly state whether prohibited political activities occurred.

⁵ Five organizations' tax-exempt status was revoked for violating the prohibition on political activity.

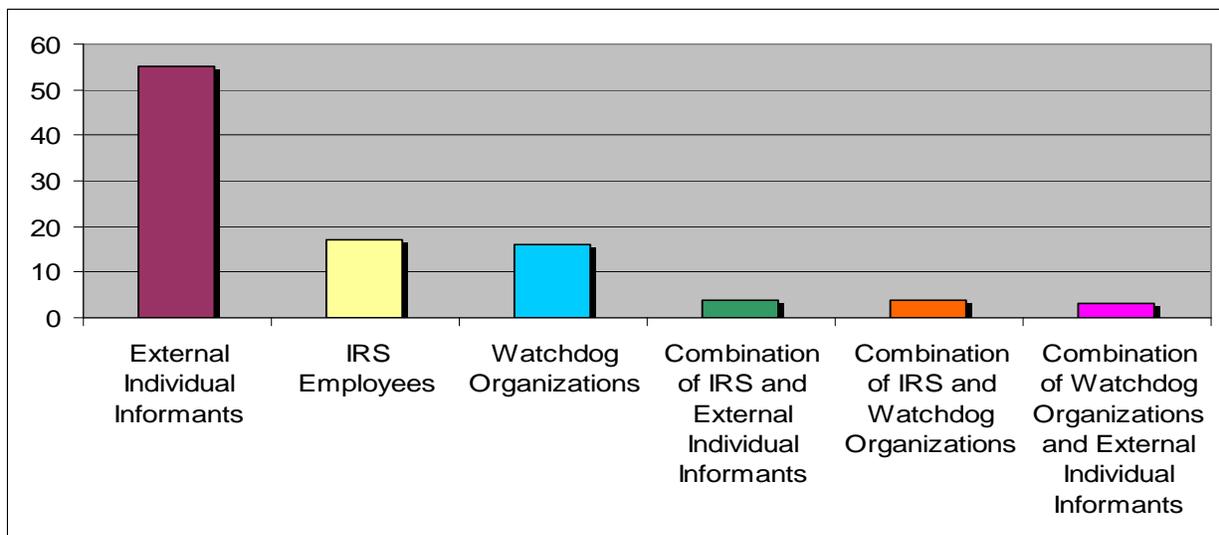


Political Activity Examinations Typically Originated From External Sources and Involved Both Churches and Charities

Examinations of tax-exempt organizations for potentially prohibited political activities are opened solely on the basis of referrals or allegations received. Referrals concerning potential prohibited activities can be received from external sources or from within the IRS. The IRS Exempt Organizations function reviews these referrals and performs research to gather evidence that will assist in making a determination on whether an examination for prohibited political activity is warranted. This evidence is then provided to an independent, experienced group of Exempt Organizations function employees, known as the Referral Committee. The Committee considers the referral and supporting evidence and decides whether the examination will be performed.

Figure 1 shows that referrals that resulted in an examination most often originated from sources external to the IRS. In total, individuals external to the IRS and watchdog organizations⁶ accounted for 74 political intervention examinations, while IRS employees accounted for 17 of the political activity examinations. The eight remaining examinations originated from both IRS employees and sources external to the IRS.

Figure 1: Source of 2004 Initiative Examinations



Source: Our review of 2004 Initiative closed examination case files.

Also, referrals that resulted in examinations for political intervention were almost evenly distributed between churches (47 percent) and charities (53 percent).

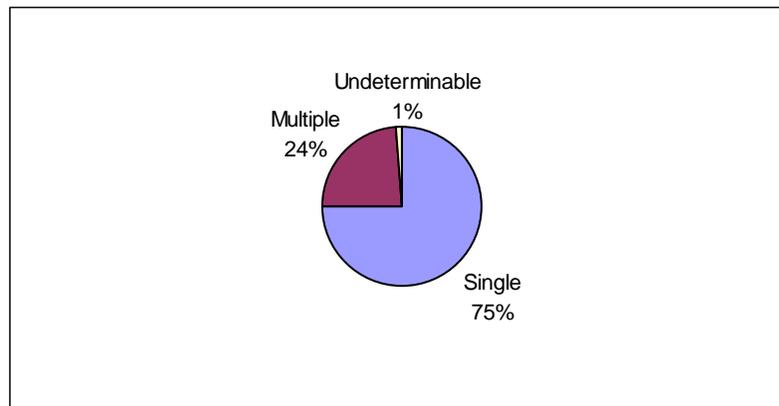
⁶ Watchdog organizations are often nonprofit groups that monitor private and Government activities and inform the public of actions it believes should be illuminated.



Political Activity Examinations Typically Involved Local Tax-Exempt Organizations Who Allegedly Committed a Single Prohibited Act

Figure 2 illustrates that most organizations were investigated for a single issue or event, while other organizations were investigated for multiple potential violations.

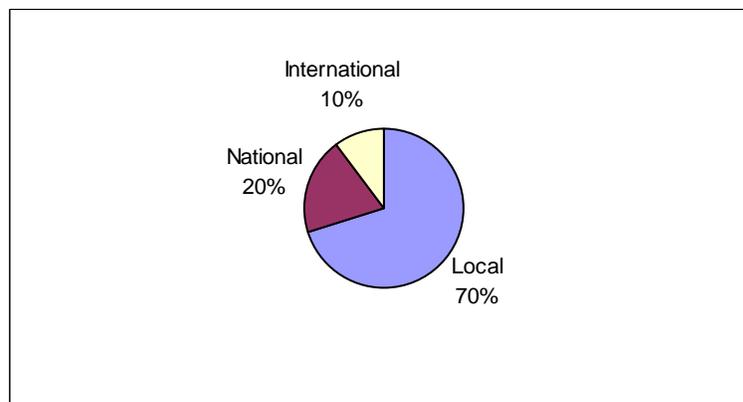
Figure 2: Number of Infractions Being Investigated Per Examination



Source: Our review of 2004 Initiative closed examination case files.

Figure 3 illustrates that the majority of the Initiative examinations involved local organizations. We defined a local organization as an organization whose outreach activities typically do not extend throughout the nation or internationally. A national organization refers to an organization whose outreach would extend to multiple geographic areas across the United States. An international organization refers to an organization whose outreach activities would extend beyond the United States borders.

Figure 3: Types of Tax-Exempt Organizations Examined in the 2004 Initiative



Source: Our review of 2004 Initiative closed examination case files.



*Statistical Profile of Alleged Political Intervention by
Tax-Exempt Organizations in the 2004 Election Season*

Political Activity Examinations Involved Tax-Exempt Organizations That Distributed Printed and Electronic Material, As Well As Made Verbal Statements and Campaign Contributions

Figure 4 shows the types of issues that were examined for political campaign intervention and the number of examinations that involved the issue.

Figure 4: Types of Issues Examined for Political Campaign Intervention

Issue Examined	Number of Cases With the Issue
Tax-exempt organizations distributed printed material (e.g., printed documents supporting candidates, improper voter guides, posted signs on its property endorsing a candidate).	46
Tax-exempt organizations made verbal statements (e.g., a church official making a statement during normal services endorsing candidates, candidates speaking at an official tax-exempt function).	35
Tax-exempt organizations distributed electronic material (e.g., endorsing candidates through tax-exempt organization web sites or links on web sites, using email listings to conduct political activities).	34
Tax-exempt organizations made inappropriate political contributions. ⁷	15

Source: Our review of 2004 Initiative closed examination case files. As noted in Figure 2, some examinations involved multiple issues, so the totals in the table exceed the total number of examinations reviewed.

The Majority of Examinations Resulted in Warning Letters Being Sent to Tax-Exempt Organizations

At the conclusion of an examination, the IRS sends a closing letter to each tax-exempt organization that has been investigated to inform them of the results of the IRS examination. As part of the examination, the Exempt Organizations function makes a determination as to whether a tax-exempt organization participated in prohibited political activities. If so, the IRS can decide to either revoke the organization's tax-exempt status or warn the tax-exempt organization of the consequences of further prohibited political activities.

⁷ Inappropriate political contributions from tax-exempt organizations examined during the 2004 Initiative ranged from \$200 to \$50,300.



*Statistical Profile of Alleged Political Intervention by
Tax-Exempt Organizations in the 2004 Election Season*

Figure 5 shows the results reported by the IRS for 2004 Initiative examinations as of November 2008.

Figure 5: Results of 2004 Initiative as Reported by the IRS

Action Taken by the IRS	Number of Cases	Percentage of Cases
Prohibited Political Activities Were Identified – A Written Advisory Was Issued Warning the Tax-Exempt Organization of the Consequences of Future Political Intervention	70	63.6%
No Prohibited Political Activities Were Identified – A Closing Letter Was Issued to the Tax-Exempt Organization	31	28.2%
Prohibited Political Activities Were Identified – The Tax-Exempt Status Was Revoked	6	5.5%
Examination Pending	3	2.7%
Total Examination Cases	110	100%

Source: 2004 Initiative examination inventory control tracking sheet as of November 5, 2008.

***A Clear Demarcation Exists Between Organizations Whose
Tax-Exempt Status Was Revoked Versus Organizations That Retained
Their Tax-Exempt Status***

Since there are a variety of circumstances that could lead to a political activity examination, the IRS has stated that it uses the various facts and circumstances of each examination to determine whether substantiated political intervention results in a warning letter or revocation of tax-exempt status. In our review of cases where the IRS determined that prohibited political activities occurred, we determined that there was a clear differentiation between cases where an organization's tax-exempt status was revoked and cases where organizations kept their tax-exempt status and received a warning letter. We noted that the factors that seemed to weigh heavy in the IRS' determination of whether to revoke the organization's tax-exempt status or to issue a letter warning the organization to discontinue prohibited political activities tended to be 1) the egregiousness of the intervention, 2) whether the tax-exempt organization agreed to stop conducting prohibited activities, 3) whether the tax-exempt organization took steps to prevent future prohibited activities, and 4) whether the tax-exempt organization agreed it was not operating as a tax-exempt organization.



*Statistical Profile of Alleged Political Intervention by
Tax-Exempt Organizations in the 2004 Election Season*

Excise Taxes on Political Activities Are Difficult to Assess

At the conclusion of an examination, the IRS can assess an excise tax if it can determine the amount of tax-exempt assets used to support prohibited political activities. However, in some cases, excise taxes do not apply because tax-exempt assets were not used (e.g., a tax-exempt official making a partisan speech at a tax-exempt function). In other cases, it is difficult for the IRS to calculate the amount of tax-exempt assets used in a prohibited activity. To assess an excise tax, the IRS must establish that assets of the organization were used to support prohibited political activities and it also must be able to determine the amount of the expenditure. For example, if an organization posts political comments on its web site, it is difficult for the IRS to determine how much the distribution of these comments actually cost. In addition, the Commissioner, Tax Exempt and Government Entities Division, stated that excise tax assessments on political expenditures are difficult to uphold due to the requirement that violations be “willful” on the part of the tax-exempt organization. As a result, it is rare for the IRS to assess excise taxes at the conclusion of an examination regarding political intervention. In 5 (5 percent) of the 99 cases, the IRS assessed excise taxes in the amount of \$12,945.37.

Initiative Results Were Misstated

The IRS uses disposal codes to document the results of Initiative examinations on its inventory system. Since Initiative results are reported to external stakeholders and may be used to make future management decisions, sound management practices dictate that the results of Initiative examinations be documented and reported accurately. However, based on our review of case files, we determined that Initiative results communicated to external stakeholders were inaccurate. IRS records show that 68 tax-exempt organizations in the 99 case files we reviewed violated the prohibition against political activities and were issued a warning letter. However, the case files showed that only 54 tax-exempt organizations actually violated the prohibition against political activities. We agree that the noncompliance rate is still high; however, information prepared for external stakeholders needs to accurately reflect the results of examinations.⁸

In addition to misstating results of the 2004 Initiative, the Exempt Organizations function continues to research and monitor organizations that violated the prohibition to provide some assurance that prohibited political activities have ceased. Since results were misclassified for 14 tax-exempt organizations, IRS resources may have been used unnecessarily to perform the followup work. The Initiative Team Leader stated that this occurred because initially there was confusion over how to classify case results on the inventory system.

Since the 2004 Initiative, IRS management incorporated training so that examiners are guided on the use of the correct disposal code, which indicates whether political intervention was

⁸ See Appendix IV.



Statistical Profile of Alleged Political Intervention by Tax-Exempt Organizations in the 2004 Election Season

substantiated. In addition, the Initiative Team Leader reviews all case closings with the IRS examiner to ensure the examination is classified correctly. While training has been updated and the Initiative Team Leader is taking action to ensure results are recorded accurately, the procedures in effect at the time of our audit do not include guidance on choosing the correct disposal code when political intervention is not substantiated. Clarifying procedures will further reduce the risk of reporting inaccurate results to external stakeholders.

Recommendation

Recommendation 1: The Director, Exempt Organizations, should create and issue guidance to ensure that IRS examiners are guided on the use of the correct disposal code when political intervention is not substantiated.

Management's Response: The Commissioner, Tax Exempt and Government Entities Division, agreed with the finding and has completed corrective actions to address this recommendation. Guidance has been created and presented in Initiative training materials, including sample closing letters for examiners to use. Examiners are instructed to refer to and comply with this guidance in working Initiative cases. As a check to ensure that this guidance is followed, the Initiative Team Leader is required to approve all closing letters before issuance. As part of this process, the correct disposal code is provided to the examiner. This guidance is presented during training and is reinforced in regular conference calls with examiners, managers, the Team Leader, Counsel, and others.

Closing Letters Issued at the Conclusion of an Examination Were Not Always Clear

Upon initiating an examination, the IRS sends a letter to the tax-exempt organization alerting them of the IRS' intent to conduct an examination for potential prohibited political activity. The examination is used to gather additional evidence to determine whether a tax-exempt organization conducted prohibited political activities. At the conclusion of an examination, the IRS sends a closing letter to the tax-exempt organization that was examined. The closing letter is used to inform a tax-exempt organization of the results of an examination. It also provides an opportunity to educate tax-exempt organizations on whether activities under examination are prohibited.

While we were compiling statistical information regarding the results of political activity examinations, we discovered it was sometimes difficult to determine from the closing letters sent to tax-exempt organizations whether the IRS substantiated that prohibited political activity had occurred. In 15 (15 percent) of the 99 case files we reviewed, the IRS did not clearly state in the closing letter whether it substantiated that the tax-exempt organization conducted inappropriate political activities, which can be confusing for tax-exempt organizations. For example, we found



***Statistical Profile of Alleged Political Intervention by
Tax-Exempt Organizations in the 2004 Election Season***

By their very nature, IRS examinations are highly intrusive and require resources of both the IRS and the tax-exempt organization being examined. In addition, some political activity examinations are lengthy due to their complexity and the fact that certain cases involve additional legal requirements that must be followed. For example, some of the initial examinations in the 2004 Initiative were started in late 2004, while some of the examinations were not completed until mid-2007 or early 2008, and three were still ongoing when we completed our fieldwork. The lack of clear and timely feedback at the end of a lengthy examination can be a burden on tax-exempt organizations.⁹ When organizations have not violated the prohibition on political activity, clear feedback is needed to notify the tax-exempt organization that it may continue to operate consistent with its tax-exempt status and to provide assurance that the alleged political actions did not violate prohibited political activity guidelines. Similarly, when tax-exempt organizations have violated the prohibition on political activity, clear feedback is needed to ensure that prohibited activities are stopped and that corrective actions are taken to prevent these types of activities in the future.

Closing letters were sometimes silent on whether the prohibition had been violated because of a lack of guidance to ensure closing letters to tax-exempt organizations clearly state whether prohibited political activities occurred. The 2004 Initiative was the first Exempt Organizations function Examination program to focus exclusively on prohibited political activity. As such, the Internal Revenue Manual did not have unique procedures for initiating and conducting examinations or for notifying organizations of the examination results.

Since the 2004 Initiative, sample closing letters are now included in training material that is given to all examiners who are involved in political activity examinations. Also, upon concluding an examination for political activities, the closing letters are now reviewed by a person specializing in the Initiative. While processes have changed since the 2004 Initiative and training has been updated, the procedures in effect at the time of our audit do not include copies of the sample closing letters or any other guidance for preparing the closing letter issued at the conclusion of an examination and ensuring it clearly states whether or not the IRS determined the tax-exempt organization violated the prohibition against political intervention. Clarifying procedures will further reduce the risk of issuing closing letters that do not provide clear feedback concerning political activities examinations.

⁹ See Appendix IV.



*Statistical Profile of Alleged Political Intervention by
Tax-Exempt Organizations in the 2004 Election Season*

Recommendation

Recommendation 2: The Director, Exempt Organizations, should create and issue guidance to ensure that closing letters to tax-exempt organizations clearly state whether a prohibited political activity violation was substantiated.

Management's Response: The Commissioner, Tax Exempt and Government Entities Division, agreed with the finding and has completed corrective actions to address this recommendation. The Exempt Organizations function has created and issued guidance in its Initiative training materials, including providing sample closing letters for use by examiners. IRS examiners are instructed to refer to and comply with this guidance in working Initiative cases. As a check to ensure this guidance is followed, the Initiative Team Leader, using the Initiative training materials, is required to review and approve all closing letters before issuance to ensure that closing letters to tax-exempt organizations clearly state whether a prohibited political activity violation was substantiated. This guidance is presented during training and is reinforced in regular conference calls with examiners, managers, the Initiative Team Leader, Counsel, and others.



*Statistical Profile of Alleged Political Intervention by
Tax-Exempt Organizations in the 2004 Election Season*

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to provide nationwide statistical information for the 2004 Political Activities Compliance Initiative (hereafter referred to as the Initiative) and determine how the Exempt Organizations function addressed political activity noncompliance. To accomplish the objective, we:

- I. Determined the source of the 2004 Initiative referrals.
 - A. Internal (IRS employees).
 - B. External
 1. Watchdog organizations.
 2. Individuals outside the IRS.
 - C. Combination of both internal and external sources.
- II. Determined whether criteria for closing examinations with a “no change,”¹ a written advisory, or a revocation was applied consistently and whether any excise taxes were assessed.
 - A. Determined the number of examination cases by type of closure.
 1. No Change.
 2. No Change – Written advisory letter issued for substantiated noncompliance.
 3. Tax-exempt status revoked for substantiated noncompliance.
 - B. Determined the number of cases and the total amount of excise taxes that were imposed on tax-exempt organizations.
 - C. Reviewed written guidance outlined in the Internal Revenue Manual and applicable revenue procedures and interviewed Exempt Organizations Examination function employees to determine criteria for examination cases closed as 1) no change with written advisory and 2) revocation of tax-exempt status.
 - D. Requested and reviewed all of the completed examination closed case files for the 2004 Initiative. Reviewed the cases to determine whether the closure criteria were consistently applied by identifying any cases where similar facts and circumstances resulted in a different outcome or type of closure.

¹ Examinations are closed as “no change” when the IRS has determined that the tax-exempt organization did not violate the prohibition on political activity.



*Statistical Profile of Alleged Political Intervention by
Tax-Exempt Organizations in the 2004 Election Season*

- III. Determined the method of political intervention substantiated through examinations.
 - A. Distribution of printed material (e.g., printed documents supporting candidates, improper voter guides, posted signs on an organization's property endorsing a candidate, or use of an organization's non-profit postal rate to mail out political materials).
 - B. Verbal statements (e.g., church official making a statement during normal services endorsing candidates, or candidates speaking at an official tax-exempt function).
 - C. Distribution of electronic material (e.g., endorsing candidates through tax-exempt organization web sites or links on web sites, or using email listings to conduct political activities).
 - D. Making direct or indirect political contributions.
- IV. Determined the magnitude of political intervention substantiated through examinations.
 - A. Determined whether the examinations involved national or local politics.
 - B. Determined the type of organization (church versus non-church) identified in the examination.
 - C. Determined whether the examinations involved single or multiple infractions.
 - D. Determined the size (local, national, or international) of the tax-exempt organizations determined to have participated in inappropriate political activities.

Internal Controls Methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. While part of this review was limited to providing statistical information on the 2004 Initiative, part of our review involved how the Exempt Organizations function addressed political activity noncompliance. For this portion of the audit, we determined that the following internal controls were relevant to our audit objectives: the Exempt Organizations function's policies, procedures, and practices for closing Initiative cases. We evaluated these controls by interviewing management and reviewing case files.



*Statistical Profile of Alleged Political Intervention by
Tax-Exempt Organizations in the 2004 Election Season*

Appendix II

Major Contributors to This Report

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*Statistical Profile of Alleged Political Intervention by
Tax-Exempt Organizations in the 2004 Election Season*

Appendix III

Report Distribution List

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Audit Liaison: Director, Communications and Liaison, Tax Exempt and Government Entities
Division SE:T:CL



***Statistical Profile of Alleged Political Intervention by
Tax-Exempt Organizations in the 2004 Election Season***

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Reliability of Information – Actual; 14 examination cases misclassified (see page 9).

Methodology Used to Measure the Reported Benefit:

Based on our review of case files, we determined that Initiative results communicated to external stakeholders were inaccurate. IRS records show that 68 tax-exempt organizations in the 99 case files we reviewed violated the prohibition against political activities and were issued a warning letter. However, case files showed that only 54 of the 68 tax-exempt organizations actually violated the prohibition against political activities.

Type and Value of Outcome Measure:

- Taxpayer Burden – Actual; 15 tax-exempt organizations affected (see page 10).

Methodology Used to Measure the Reported Benefit:

While we were compiling statistical information regarding the results of political activity examinations, we discovered it was difficult to determine from the closing letter sent to the tax-exempt organization whether the IRS substantiated that prohibited political activity had occurred. In 15 (15 percent) of the 99 cases we reviewed, the IRS did not clearly state in the closing letter whether it substantiated that the tax-exempt organization conducted inappropriate political activities, which can be confusing for tax-exempt organizations. For example, we found



The lack of clear and timely feedback at the end of a lengthy examination can be a burden on tax-exempt organizations.



*Statistical Profile of Alleged Political Intervention by
Tax-Exempt Organizations in the 2004 Election Season*

Appendix V

Management's Response to the Draft Report



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



APR 20 2009

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: *J. Callahan*
Commissioner, Tax Exempt and Government Entities
Division

SUBJECT: Response to Draft Audit Report – Statistical Profile of Alleged
Political Intervention by Tax-Exempt Organizations in the 2004
Election Season (Audit # 200810033)

This responds to your draft audit report concerning the Exempt Organizations
(EO) function's 2004 Political Activity Compliance Initiative (PACI).

Your report is a careful statistical review of the examinations EO performed
during the 2004 PACI. It notes that most referrals originated from sources
external to the IRS, most examinations involved a single issue or event and that
most of the organizations examined were local rather than national or
international organizations. Among other things, your report also notes that there
was a clear demarcation between those organizations whose tax-exempt status
was revoked and those that retained their tax-exempt status.

You recommend that we create and issue guidance concerning the closing codes
and closing letters we use in the PACI. Your report recognizes that, since the
period you reviewed, we have created and issued such guidance as part of our
training materials and processes. The report notes, however, that the PACI
procedures in effect during the 2004 PACI did not include this guidance. Our
current training materials implement the recommendations in your report, and are
an integral part of current PACI procedures.

Our specific response to your recommendations appears on the attachment.

Finally, we concur with your assessment of the measurable benefits on tax
administration.

Attachment



*Statistical Profile of Alleged Political Intervention by
Tax-Exempt Organizations in the 2004 Election Season*

Attachment

Recommendation 1

The Director, Exempt Organizations, should create and issue guidance to ensure that IRS examiners are guided on the use of the correct disposal code when political intervention is not substantiated.

Corrective Action

EO has created and issued guidance in its PACI training materials, including providing sample closing letters for use by the agents. IRS examiners are instructed to refer to and to comply with this guidance in working PACI cases. As a check to insure that this guidance is followed, the PACI project leader, also referring to and relying on the PACI training materials, is required to review and approve all closing letters before issuance. As part of this review and approval process, he or she provides the correct disposal code to be used by the agent. We present this guidance during training, and reinforce it in regular conference calls with agents, managers, the PACI project leader, Counsel and others.

Implementation Date

Completed

Responsible Official

Lois G. Lerner, Director, EO

Recommendation 2

The Director, Exempt Organizations, should create and issue guidance to ensure that closing letters to tax-exempt organizations clearly state whether a prohibited political activity violation was substantiated.

Corrective Action

EO has created and issued guidance in its PACI training materials, including providing sample closing letters for use by the agents. IRS examiners are instructed to refer to and to comply with this guidance in working PACI cases. As a check to insure that this guidance is followed, the PACI project leader, also referring to and relying on the PACI training materials, is required to review and approve all closing letters before issuance to ensure that closing letters to tax-exempt organizations clearly state whether a prohibited political activity violation was substantiated. We present this guidance during training, and reinforce it in regular conference calls with agents, managers, the PACI project leader, Counsel and others.

Implementation Date

Completed

Responsible Official

Lois G. Lerner, Director, EO