

**Review of the Exempt Organizations Function
Process for Reviewing Alleged Political
Campaign Intervention by Tax Exempt
Organizations**

February 2005

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

February 17, 2005

MEMORANDUM FOR COMMISSIONER, TAX EXEMPT AND GOVERNMENT
ENTITIES DIVISION

A handwritten signature in cursive script, reading "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Review of the Exempt Organizations
Function Process for Reviewing Alleged Political Campaign
Intervention by Tax Exempt Organizations (Audit # 200510008)

This report presents the results of our review of the Exempt Organizations (EO) function process for reviewing alleged political campaign intervention by tax exempt organizations. The overall objective of this review was to evaluate the Tax Exempt and Government Entities (TE/GE) Division's recently established process for reviewing information alleging political campaign intervention by Internal Revenue Code (I.R.C.) § 501(c)(3)¹ organizations and for initiating any associated examinations of these organizations. Specifically, we determined the process established by TE/GE Division management to review referrals of potential political campaign intervention and assessed whether referrals were processed in accordance with established procedures.

In November 2004, the Treasury Inspector General for Tax Administration (TIGTA) received separate requests from the Commissioner of the Internal Revenue Service (IRS) and the Commissioner, TE/GE Division, to evaluate the new process used by the IRS to review allegations of potential political activities by tax exempt organizations. There had been several media reports of allegations that the TE/GE Division was examining this type of activity just before the 2004 Presidential election for politically motivated reasons. We limited our audit to a review of the process followed by the EO function for reviewing these allegations and did not determine whether the activities by the tax exempt organizations involved potentially prohibited political activity. We were alert for any indications that inappropriate actions, such as political influence, may have been taken with regard to the handling of these referrals. Based on the extent of our

¹ I.R.C. § 501(c)(3) (2004).

audit work, we did not identify any indications that the EO function inappropriately handled the information items we reviewed. Furthermore, we did not make any referrals to the TIGTA Office of Investigations during this audit.

In summary, the TE/GE Division took several actions in 2004 to address potential political campaign intervention by tax exempt organizations. Specifically, TE/GE Division management provided education and outreach activities to § 501(c)(3) organizations on their responsibilities related to political activities. In addition, the EO function established a new expedited process to review allegations of potential political intervention by tax exempt organizations because EO function management anticipated an increase in these types of allegations during the 2004 election year. In June 2004, EO function management initiated a Political Intervention Project (PIP) at the request of the Commissioner, TE/GE Division. The main goal of the PIP was to establish a “fast track” process to respond quickly to referrals of potential political intervention during the 2004 election year and prevent recurring violations by the same organizations.

We reviewed samples of information items processed under the PIP during the period July 30, 2004, through November 22, 2004, to determine whether the EO function processed the allegations in accordance with established procedures.² Based on our samples, we determined the EO Referral Committee followed a consistent process when reviewing the information items, regardless of the source of the allegation or the potential political activity. Specifically, the sampled information items were reviewed by a three-person EO Referral Committee of experienced EO function technical employees, as required. In addition, the EO Referral Committee’s decision of whether an allegation warranted an examination was documented in each case file. EO function management informed us the EO Referral Committee evaluated the information items based on the “reasonable belief standard.”³ Further, we analyzed the EO Referral Committee’s decisions and did not identify any cases in which the same criteria were used to select one information item for examination and to decline a similar item for examination.

However, EO function management experienced delays in expediting the classification and examination processes. Specifically, the EO Classification Unit did not always ensure information items were classified and directed to a field examination group timely, contact letters were not always issued to taxpayers within the expedited period,

² We randomly selected 40 of the 80 information items for which the EO Referral Committee determined an examination was warranted, randomly selected 20 of the 41 items for which an examination was not warranted, and selected all 10 of the information items that were classified and determined to be inaccurately categorized as potential political activity, for a total of 70 cases. For the 20 cases, the EO Referral Committee identified several reasons for not selecting the items for examination, including the alleged activity was not prohibited political activity; the referral did not contain a specific, supported allegation of political activity; and the organization was not a § 501(c)(3) organization. For the 10 cases that were inaccurately categorized, the EO Referral Committee determined the allegations did not always contain specific, supported allegations of political activity or the organization was not a § 501(c)(3) organization.

³ For “reasonable belief” to be met, the Committee must determine an information item demonstrates that a violation of the tax laws may have occurred or it appears likely that an examination will lead to the discovery of a violation.

and notices of tax inquiry for issuance to churches were not reviewed and approved within the 15 workday expedited period.

EO function management's ability to effectively accelerate case initiations for potential political intervention allegations was affected by a lack of clear guidance, inadequate resources, and the late initiation of the PIP with less than 5 months remaining before the 2004 elections. As a result, the first contact letter sent to an organization as part of the PIP was not issued until September 21, 2004, 6 weeks before the scheduled elections. Although the IRS' ability to contact tax exempt organizations as part of the PIP is not limited by the timing of the Presidential election, we believe contacting organizations so close to the election and the late publicity about this project contributed to the allegations of improper motivation on the part of the IRS.

During our fieldwork, EO function management decided to discontinue the "fast track" processing of allegations of potential political intervention by § 501(c)(3) organizations. This decision was based on completion of the 2004 elections and was effective for all information items received after November 30, 2004.

We recommended the Director, EO, formalize the draft guidelines that detail how allegations of potential noncompliance with the tax laws by tax exempt organizations should be classified. In addition, the Director, EO, should establish realistic time standards for when information items should be classified and forwarded to an examination group, if warranted, for both election and nonelection years. Additionally, the Director, EO, should ensure any future expedited review process is initiated early enough in an election year to ensure classification and examination actions are completed timely and consistently. Further, to increase public awareness, we recommended the Commissioner, TE/GE Division, should issue a press release in future election years if the IRS plans to implement an expedited process to review allegations of potential political intervention.

Management's Response: The IRS agreed with our recommendations and indicated it is evaluating the prohibited political activity program as it operated during the last election cycle. Based on this evaluation, the IRS expects to make a number of decisions on changes to the program for the next election cycle. TE/GE Division management has drafted and will make effective procedures that specify how allegations of potential noncompliance by tax exempt organizations should be classified. In addition, procedures for future election years and nonelection years will provide realistic time periods for processing information items alleging potential political intervention. TE/GE Division management has drafted and the Director, EO Examinations, is considering procedures for future election years that will ensure the process is initiated early enough to allow classification and examination actions to be completed timely and consistently. Finally, the Commissioner, TE/GE Division, has requested the Director, Communications and Liaison, TE/GE Division, to prepare a press release in future election years advising the exempt organizations community that allegations of potential noncompliance with the tax laws relating to political activity will be processed on an expedited basis. Management's complete response to the draft report is included as Appendix IV.

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 Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.

**Review of the Exempt Organizations Function Process for Reviewing Alleged
Political Campaign Intervention by Tax Exempt Organizations**

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Review of the Exempt Organizations Function Process for Reviewing Alleged Political Campaign Intervention by Tax Exempt Organizations

Background

Under the Internal Revenue Code (I.R.C.), § 501(c)(3)¹ organizations are exempt from Federal income tax. Charities, educational institutions, and religious organizations, including churches, are among those that are covered under this Code section. To qualify for and maintain tax exempt status under I.R.C. § 501(c)(3), an organization must be organized and operated exclusively for its tax exempt purpose.

While many charities speak out on public issues as an integral part of carrying on their tax exempt function, the I.R.C. prohibits § 501(c)(3) organizations from the following types of political activities:

- Directly or indirectly participating in, or intervening in, any political campaign on behalf of (or in opposition to) any candidate for elective public office.
- Making contributions to political campaign funds.
- Making public statements (verbal or written) in favor of or in opposition to any candidate for public office.
- Engaging in activities that may be beneficial for or detrimental to any particular candidate. These activities may constitute intervention, even if they do not expressly call for the election or defeat of a particular candidate, if the activity contains reasonably overt communication that the organization supports or opposes a particular candidate.

Violation of this I.R.C. prohibition may result in denial or revocation of tax exempt status for the § 501(c)(3) organization and the imposition of certain excise taxes on the amount of money spent on the prohibited activity.

The Exempt Organizations (EO) function of the Tax Exempt and Government Entities (TE/GE) Division has responsibility for ensuring charitable or other tax exempt organizations are in compliance with the I.R.C. Allegations of potential noncompliance with the I.R.C., including

¹ I.R.C. § 501(c)(3) (2004).

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allegations of potential political activity by § 501(c)(3) organizations, are reviewed by the EO function. The EO function may conduct an examination to determine if the political activity is a violation of the law and if enforcement action is warranted. EO function personnel select an organization for examination based on information contained on the tax return filed with the Internal Revenue Service (IRS). However, the IRS also has authority to examine a reporting period in which the tax return has not been filed and is not yet due.

In November 2004, the Treasury Inspector General for Tax Administration (TIGTA) received separate requests from the Commissioner of the IRS and the Commissioner, TE/GE Division, to evaluate the new process used by the IRS to review allegations of potential political activities by tax exempt organizations. There had been several media reports of allegations that the TE/GE Division was examining this type of activity just before the 2004 Presidential election for politically motivated reasons. Because the IRS (not the TIGTA) has the authority to administer the internal revenue laws,² which includes determining whether tax exempt organizations are in compliance with those laws, we limited our audit to a review of the process followed by the EO function for reviewing these allegations and did not determine whether the activities by the tax exempt organizations involved potentially prohibited political activity. We were alert for any indications that inappropriate actions, such as political influence, may have been taken with regard to the handling of these referrals. Any inappropriate actions, including political influence, would have been referred to the TIGTA Office of Investigations for review.

This review was performed at the EO function National Headquarters in Washington, D.C., and the EO Examinations office in Dallas, Texas, during the period November 2004 through January 2005. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective,

² I.R.C. § 7803(a) (2004).

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The Tax Exempt and Government Entities Division Took Several Actions in 2004 to Address Allegations of Potential Political Campaign Intervention by Tax Exempt Organizations

scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Based on our discussions with TE/GE Division management and review of applicable documentation, we determined TE/GE Division management took several actions during 2004 to address potential political campaign intervention by tax exempt organizations. Specifically, TE/GE Division management provided education and outreach activities to I.R.C. § 501(c)(3) organizations on their responsibilities related to political activities. In addition, the EO function established a new process to review allegations of potential political intervention by tax exempt organizations on an expedited basis to respond quickly to these allegations and prevent recurring violations.

The TE/GE Division took actions in 2004 to remind tax exempt organizations of prohibited political activities

We determined the IRS took several actions during the 2004 election year to remind § 501(c)(3) organizations of the prohibition against engaging in improper political intervention, including:

- Workshops conducted by EO function personnel in seven states during May and June 2004 that included a topic on political activities.
- Presentations that addressed prohibited political activities at the IRS Nationwide Tax Forums held in six states during July through September 2004.
- An April 2004 press release discussing prohibited political campaign activities for tax exempt organizations. IRS management indicated they issued similar election-year advisories in 1992, 1996, and 2000.
- A letter related to prohibited political activities, issued in June 2004 to seven national political parties. These included the Republican, Democratic, and Libertarian National Committees and the Green Party of the United States.
- An October 2004 press release reiterating prohibited political activities and outlining IRS enforcement

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activity taken to address potential prohibited political activities by tax exempt organizations.

The EO function established a “fast track” process to review allegations of potential political intervention by exempt organizations

While the EO function receives information items³ of potential political intervention by § 501(c)(3) organizations throughout the year, EO function management anticipated an increase in these types of information items during the 2004 election year. To respond to these referrals, EO function management initiated a Political Intervention Project (PIP). The main goal of the PIP was to establish a “fast track” process to respond quickly to referrals of potential political intervention during the 2004 election year and prevent recurring violations by the same organizations. The PIP used the EO function’s existing process for evaluating referrals, except that it allowed for accelerated case initiations in both the classification and examination processes. EO function management intended for the PIP to remain in effect until the completion of the 2004 election year, when it would be reevaluated for use in future years.

Based on our review of available documentation, the PIP was initiated in June 2004 at the request of the Commissioner, TE/GE Division. On July 26-30, 2004, an eight-member team met in Dallas, Texas, to develop an expedited process to classify and, if warranted, examine information items alleging political intervention by § 501(c)(3) organizations. The team developed proposed procedures for PIP cases, including:

- Establishing an expedited time period for completing the classification of potential political intervention referral cases and directing the cases to an examination group, if warranted, within 7-10 workdays following the receipt of the referrals in the EO Classification Unit. (For non-PIP cases, the EO Classification Unit is required to begin

³ An information item is a communication received by the EO function from an internal or external source related to potential noncompliance with the tax law by an exempt organization, political organization, taxable entity, or individual.

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evaluating information items within 60 days of their receipt in the Unit; however, there is no time standard for completing the classification of non-PIP cases.)

- Requiring the EO Classification Unit's EO Referral Committee to determine which cases should be worked as correspondence examination or field examination.
- Developing contact letters for informing nonchurch § 501(c)(3) organizations that they have been selected for an examination.
- Establishing an expedited review and approval process for the notices of tax inquiries sent to churches to inform them the IRS is considering initiating an examination.

During August 2004, the TE/GE Division revised the proposed PIP procedures and contact letters to be sent to organizations selected for expedited examinations. The EO Classification Unit manager sent the proposed procedures to the EO Examinations office area managers for implementation on August 24, 2004; however, the procedures were not formally issued by the Director, EO Examinations. The contact letters and related attachments were approved for issuance as of September 15, 2004. Consequently, the first contact letter sent to an organization as part of the PIP was not issued until September 21, 2004.

We determined the EO function has draft guidelines for processing, controlling, and tracking all types of information items received by EO function personnel concerning the activities of tax exempt organizations. EO function personnel stated they follow these guidelines when reviewing information items, but the guidelines have been in "draft" status for an extended period and have not been finalized.

According to the draft guidelines, a classifier in the EO Classification Unit is generally responsible for reviewing an information item to determine if the item has examination potential unless the information item is required to be reviewed by the EO Referral Committee. The EO Referral Committee reviews the information items containing

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evidence or allegations of political activities as well as any type of allegations pertaining to churches.

Based on our review of documentation and interviews with TE/GE Division management, the EO Referral Committee was comprised of three members, who were experienced EO function technical employees (e.g., senior examiners, classification specialists, or group managers). The Committee is responsible for considering, in a fair and impartial manner, whether information items referred have examination potential. To make this decision, the Committee evaluates whether an information item meets the “reasonable belief standard” using their experience, judgment, and concern for fairness. For “reasonable belief” to be met, the Committee must determine an information item demonstrates that a violation of the tax laws may have occurred or it appears likely that an examination will lead to the discovery of a violation.

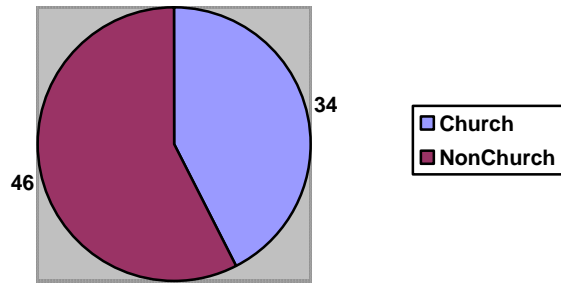
The PIP included two sets of information items, all of them alleging political intervention by § 501(c)(3) organizations. The primary set involved information items received by the EO Classification Unit on or after July 30, 2004. These cases were subject to both expedited classification and expedited examination processing. The second set involved information items received before July 30, 2004, that were in the EO Classification Unit’s inventory or information items that involved potential political activity by § 501(c)(3) organizations that were assigned to an examination group but for which no taxpayer contact had been made. These cases were subject to expedited examination processing but not the expedited classification.

Based on information provided by EO function management, we determined that, during the period July 30, 2004, through November 22, 2004, the EO Referral Committee reviewed 131 information items alleging potential political activities by tax exempt organizations. The committee determined 10 information items were inaccurately categorized as potential political activities because they did not involve political activities. Of the remaining 121 information items, the EO Referral Committee determined 80 items warranted an examination based on the “reasonable belief” criteria and 41 items did

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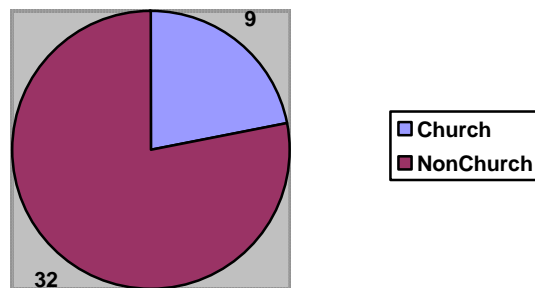
not warrant an examination. Figures 1 and 2 break down these cases by type of organization.

Figure 1: 80 Organizations Selected for Examination



Source: TE/GE Division data.

Figure 2: 41 Organizations Not Selected for Examination



Source: TE/GE Division data.

The “fast track” processing was discontinued as of December 1, 2004

During the fieldwork phase of our review, EO function management decided to discontinue the “fast track” processing of allegations of potential political intervention by § 501(c)(3) organizations. This decision was based on completion of the 2004 elections and was effective for all information items received after November 30, 2004.⁴ Based on our discussion with EO function management, a classifier will begin evaluating information items received after that date within 60 days (rather than classifying and

⁴ EO function management considers the election cycle to end on November 30th of even numbered years.

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directing items to an EO Examinations office group within 7-10 workdays of receipt). All cases processed under the “fast track” procedures prior to December 1, 2004, and assigned to the EO Examinations office were still required to be processed under the “fast track” examination procedures implemented in August 2004. At the end of our fieldwork, EO function management was evaluating whether an expedited process will be implemented in future election years.

EO function management has also designated potential political intervention referral cases as priority work for the EO Examinations office in Fiscal Year (FY) 2005, indicating the TE/GE Division’s continued emphasis in this area.

Allegations of Potential Political Campaign Intervention Were Handled Consistently but Were Not Always Processed Timely

We reviewed samples of information items processed under the PIP to determine whether the EO function processed the allegations in accordance with established procedures. Based on our samples, we determined the EO Referral Committee followed a consistent process when reviewing the information items, regardless of the source of the allegation or the potential political activity. Specifically, the sampled information items were reviewed by a three-person EO Referral Committee of experienced EO function technical employees, as required. In addition, the EO Referral Committee’s decision of whether an allegation warranted an examination was documented in each case file. EO function management informed us the EO Referral Committee evaluated the information items based on the “reasonable belief standard.” Further, we analyzed the EO Referral Committee’s decisions and did not identify any cases in which the same criteria were used to select one information item for examination and to decline a similar item for examination. Based on the extent of our audit work, we did not identify any indications that the EO function inappropriately handled the information items we reviewed. Furthermore, we did not make any referrals to the TIGTA Office of Investigations during this audit.

However, EO function management experienced delays in expediting the classification and examination processes. Specifically, the EO Classification Unit did not always ensure information items were classified and directed to a

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field examination group timely, contact letters were not always issued to taxpayers within the expedited period, and notices of tax inquiry for issuance to churches were not reviewed and approved within the 15 workday expedited period. EO function management's ability to effectively accelerate case initiations for potential political intervention referrals was affected by a lack of clear guidance, inadequate resources, and the late initiation of the PIP with less than 5 months remaining before the 2004 elections. As a result, EO function management did not send contact letters to organizations until September 21, 2004, 6 weeks before the scheduled elections. Although the IRS' ability to contact tax exempt organizations as part of the PIP is not limited by the timing of the Presidential election, we believe contacting organizations so close to the election and the late publicity about this project contributed to the allegations of improper motivation on the part of the IRS.

To select our samples, we obtained several listings from EO function management of all "fast track" cases processed during the period July 30, 2004, through November 22, 2004. We randomly selected 40 of the 80 information items for which the EO Referral Committee determined an examination was warranted, randomly selected 20⁵ of the 41 items for which an examination was not warranted, and selected all 10⁶ of the information items that were classified and determined to be inaccurately categorized as potential political activity, for a total of 70 cases.

Information items were not always classified timely

To determine if the EO Classification Unit function timely processed the information items we selected, we used two different classification timeliness standards, depending on

⁵ The EO Referral Committee documented its decision not to select these cases for examination for various reasons, including the alleged activity was not prohibited political activity; the referral did not contain a specific, supported allegation of political activity; and the organization was not a § 501(c)(3) organization.

⁶ Our analysis of these cases determined they were similar to those categorized as not selected for examination. Specifically, the cases did not always contain specific, supported allegations of political activity or the organization was not a § 501(c)(3) organization.

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when the information items were received by the EO Classification Unit. Specifically, information items received in the Unit before July 30, 2004, were considered timely if they were assigned to a classifier within 60 days of receipt by the Unit.⁷ Information items received on or after July 30, 2004, were considered timely if they were classified and sent by the EO Classification Unit to an examination group, if warranted, within 10 workdays of receipt by the Unit. As shown in Figure 3, the EO function did not always classify information items timely.

Figure 3: Timeliness of Classification Process

EO Classification Unit Receipt Date	Number of Cases	Number Not Processed Timely	Percentage Not Processed Timely	Range of Untimeliness (days)
Before 07/30/04	37	4	10.8	1-77 (avg 24 days late)
On or After 07/30/04	33	25	75.8	1-40 (avg 19 workdays late)
Totals	70	29	41.4	

Source: TIGTA analysis of selected information items.

We analyzed the 25 untimely processed information items received on or after July 30, 2004, and identified 2 main causes of untimeliness: delay in classifying the information items by the EO Referral Committee (it took an average of 15 workdays for the EO Referral Committee to classify the items after receipt in the Unit) or delay by the EO Classification Unit in sending the cases to an examination group after a decision was made by the EO Referral Committee (18 of the 25 items were selected for examination but were not sent to an examination group until an average of 19 workdays after review by the EO Referral Committee).

⁷ We considered the evaluation of information items to begin when they were assigned to a classifier.

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Although the PIP team requested additional resources to meet the expedited time standards, the EO Classification Unit may not have had sufficient resources to meet the PIP time standards. The Unit was allocated only an additional .5 Full-Time Equivalent⁸ to assist in meeting the expedited PIP time periods during the project. EO function management stated EO Classification Unit staffing shortages caused delays in the case-building process (conducting research of both internal and external databases) when information items were received, as well as delays in updating internal databases and preparing the case files before they were sent to EO Examinations office personnel after the EO Referral Committee determined an examination was warranted.

As shown in Figure 3, classifiers timely began the evaluations (i.e., within 60 days of receipt) for the majority of cases in our samples received in the EO Classification Unit before July 30, 2004. However, the information items were not classified by the EO Referral Committee until an average of 111 days (almost 4 months) after receipt by the EO Classification Unit. In addition, when examinations were warranted, the Unit did not send the information items to an examination group until an average of 126 days (an additional 4 months) after the items were classified by the EO Referral Committee.

With the decision to discontinue the expedited processing of potential political intervention referrals and the lack of a time standard for classifying cases, future referrals may once again be delayed in classification. To ensure all information items are evaluated timely, the EO function should establish, for both election years and nonelection years, clear time standards for when these information items should be classified and forwarded to an examination group, if warranted.

⁸ A Full-Time Equivalent (FTE) is a measure of labor hours. One FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year. For FY 2004, 1 FTE was equal to 2,096 staff hours. For FY 2005, 1 FTE is equal to 2,088 hours.

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Examination case processing was not always performed on an expedited basis for PIP cases

Our analysis of the examination process for the 40 randomly selected information items for which the EO Referral Committee determined an examination was warranted was limited to the initial processing by the examination group as of December 21, 2004. This included the timeliness of case assignment to an agent, issuance of contact letters to nonchurch organizations, and processing of inquiry letters required for church cases. However, TE/GE Division personnel did not always ensure the necessary actions were completed timely.

Specifically, we determined EO Examinations office management did not always ensure information items involving potential political intervention activity were assigned to an agent within the expedited period. We determined 21 (53 percent) of the 40 cases were not assigned to an agent within 1 day of receipt in the group, as required. Delays in the case assignment ranged from 1 to 30 workdays.

For nonchurch PIP cases selected for correspondence examination, a letter should be issued to an organization within 5 workdays of receipt by the agent. For nonchurch PIP cases selected for field examination, an initial letter should be sent to the organization within 2 workdays of receipt by an agent, with a second letter issued no later than 10 workdays after the initial letter. Twenty-five of the 40 information items analyzed related to nonchurch organizations. We determined 10 (40 percent) of the 25 cases had at least 1 instance of a contact letter issued to a taxpayer beyond the established time period. This included initial contact letters for both correspondence and field examinations, as well as second contact letters for field examinations. Timeliness delays ranged from 2 to 23 workdays.

For church cases, the “fast track” PIP procedures require that an inquiry letter be drafted, reviewed by the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), and sent for quality review within 15 workdays following request for assignment of an Office of Division Counsel/Associate Chief Counsel

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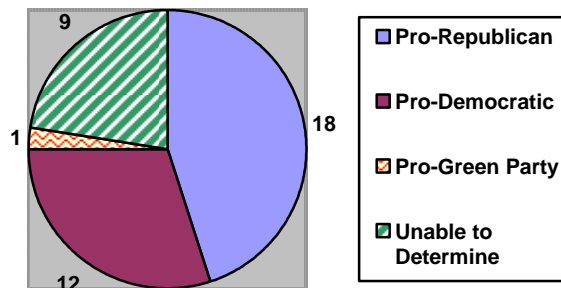
attorney. However, we determined that 6 of the 15 church cases were not sent for quality review within the 15 workday standard. Timeliness delays ranged from 3 to 41 workdays.

Based on our discussions with EO function management and review of recent PIP reports, EO function management indicated that the expedited periods for classification and examination were unrealistic. According to EO function management's analysis of PIP cases in process as of January 13, 2005, contact letters were not issued timely in 40 percent of the correspondence audits and 78 percent of the field audits. In addition, EO function management determined that inquiry letters were not processed timely in 78 percent of the church cases.

The information items we analyzed contained allegations related to various political views and were received from both internal and external sources

Based on our analysis of the information items randomly selected in our samples, we determined tax exempt organizations were allegedly performing activities that were supporting several political parties, as shown in Figures 4 and 5.

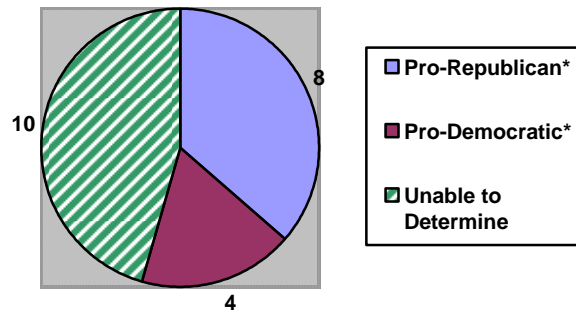
Figure 4: Potential Political Activity by the 40 Organizations Selected for Examination



Source: TIGTA analysis of 40 randomly selected information items.

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Figure 5: Potential Political Activity by the 20 Organizations Not Selected for Examination



*Two information items alleged political activity that supported both the Republican and Democratic parties and was detrimental to other political parties.

Source: TIGTA analysis of 20 randomly selected information items.

The “Unable to Determine” information items included allegations that we could not directly attribute to any political party, such as those related to local election issues or candidates for local offices.

We also determined the allegations for the items in our random samples were referred by both internal and external sources. Specifically, several information items were received from internal IRS sources, such as EO Examinations office and IRS Communications and Liaison office personnel. Other sources of information items were individual taxpayers, other Federal Government agencies, political candidates, and the Congress.

Recommendations

The Director, EO, should:

1. Formalize the draft guidelines that detail how allegations of potential noncompliance with the tax law by tax exempt organizations should be classified.

Management’s Response: TE/GE Division management has drafted and will make effective procedures that specify how allegations of potential noncompliance by tax exempt organizations should be classified.

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2. Ensure time standards for accelerated case initiation (both classification and examination) are realistic for future election years based on available resources and priorities.

Management's Response: TE/GE Division management is drafting and will issue revised political intervention procedures for future election years that contain realistic time periods. As additional data from the 2004 election cycle is collected, these procedures may be revised, if appropriate, for the 2006 election cycle.

3. Establish time standards for when potential political intervention allegations received in nonelection years should be evaluated for examination potential and sent to the examination groups, rather than just assigned to an examiner as currently required.

Management's Response: TE/GE Division management has drafted and will implement procedures that set time periods within which information items alleging potential political intervention received in nonelection years are assigned to a classifier and either sent to an examination group or determined that an examination is not warranted.

4. Ensure any future expedited review process is initiated early enough in an election year to ensure classification and examination actions are completed timely and consistently.

Management's Response: TE/GE Division management has drafted and the Director, EO Examinations, is considering procedures for future election years that will ensure the process is initiated early enough to allow classification and examination actions to be completed timely and consistently.

In addition, the Commissioner, TE/GE Division, should:

5. Issue a press release in future election years if allegations of potential noncompliance with the tax laws will be processed on an expedited basis, to increase public awareness of the expedited process.

Management's Response: The Commissioner, TE/GE Division, has requested the Director, Communications and Liaison, TE/GE Division, to prepare a press release in future

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election years advising the exempt organizations community that allegations of potential noncompliance with the tax laws relating to political activity will be processed on an expedited basis.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to evaluate the Tax Exempt and Government Entities (TE/GE) Division's recently established process for reviewing information alleging political campaign intervention by Internal Revenue Code (I.R.C.) § 501(c)(3)¹ organizations and for initiating any associated examinations of these organizations. Specifically, we determined the process established by TE/GE Division management to review referrals of potential political campaign intervention and assessed whether referrals were processed in accordance with established procedures. To accomplish the objective, we:

- I. Reviewed actions taken by TE/GE Division management during the 2004 Presidential election year to educate I.R.C. § 501(c)(3) organizations on their responsibilities related to political activities.
 - A. Interviewed Exempt Organizations (EO) function management to determine any education and outreach efforts taken during the 2004 election year related to political activity.
 - B. Obtained any press releases, letters, or other correspondence/documentation issued by the TE/GE Division during this period.
- II. Determined the process established by TE/GE Division management during the 2004 election year to review referrals of political campaign intervention and to assess which organizations merit examination.
 - A. Interviewed TE/GE Division management to determine the process established during this period to review allegations of political campaign intervention.
 - B. Obtained any procedures or documentation related to the establishment of the process.
 - C. Obtained any procedures or documentation established by TE/GE Division management detailing the process that should be followed when receiving and reviewing any allegations of political campaign intervention by I.R.C. § 501(c)(3) organizations and in determining whether to initiate an examination.
- III. Assessed whether the referrals received by TE/GE Division management were processed in accordance with established procedures.
 - A. Obtained a listing of all internal and external referrals received by TE/GE Division management during the 2004 election year alleging political campaign intervention by I.R.C. § 501(c)(3) organizations.

¹ I.R.C. § 501(c)(3) (2004).

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- B. Selected three samples of the allegations received to evaluate the process followed by the TE/GE Division when determining whether an examination was warranted.
 - 1. Selected a random sample of the allegations received for which the TE/GE Division determined an examination was not warranted based on its review. We randomly selected 20 of the 41 allegations processed by the EO function during the period July 30, 2004, through November 22, 2004. We used a random sample due to time constraints and because we did not plan to project our results.
 - 2. Selected a random sample of the allegations received for which the TE/GE Division initiated an examination based on its review. We randomly selected 40 of the 80 allegations processed by the EO function during the period July 30, 2004, through November 22, 2004. We used a random sample due to time constraints and because we did not plan to project our results.
 - 3. Reviewed all 10 allegations received by the EO function during the period July 30, 2004, through November 22, 2004, which the TE/GE Division determined were inaccurately categorized as potential political intervention activities.
- C. Obtained and reviewed any case files for the sampled referrals to determine whether established procedures were followed for reviewing the referrals and for initiating any examinations.

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Appendix II

Major Contributors to This Report

Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs)

Nancy A. Nakamura, Director

Jeffrey M. Jones, Audit Manager

Theresa Berube, Lead Auditor

Margaret Anketell, Senior Auditor

Deadra English, Senior Auditor

Donald Martineau, Auditor

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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner - Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Tax Exempt and Government Entities Division SE:T
Director, Exempt Organizations, Tax Exempt and Government Entities Division SE:T:EO
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National Taxpayer Advocate TA
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Director, Office of Program Evaluation and Risk Analysis RAS:O
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Audit Liaison: Director, Communications and Liaison, Tax Exempt and Government Entities
Division SE:T:CL

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Appendix IV

Management's Response to the Draft Report



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

RECEIVED,
FEB 16 2005

FEB 15 2005

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDIT
(SMALL BUSINESS AND CORPORATE PROGRAMS)

FROM:  Steven T. Miller

SUBJECT: Commissioner, Tax Exempt and Government Entities
Response to Draft Audit Report: Review of the Exempt
Organizations Function Process for Reviewing Alleged
Political Campaign Intervention by Tax Exempt
Organizations (Audit #200510008)

This responds to your draft audit report ("report") concerning the manner in which the Exempt Organizations ("EO") function of the Tax Exempt and Government Entities Division ("TE/GE") initiated and carried out a program aimed at addressing prohibited political activity by Internal Revenue Code section 501(c)(3) organizations during the 2004 election cycle.

Your review was prompted by requests from both the Commissioner of Internal Revenue and me to look critically at the new processes EO employed in the summer and fall of 2004 to review allegations of potential political activity by tax exempt organizations. Our requests to TIGTA were prompted by public charges, reported in the media, that TE/GE was examining alleged political activity by tax exempt organizations just before the 2004 Presidential election for politically motivated reasons or in response to political direction from outside the IRS.

Your report notes that, in conducting your review, TIGTA was "alert for any indications that inappropriate actions, such as political influence, may have been taken" with regard to EO's handling of the information items sent to it. The report also notes that if you had found inappropriate actions, you would have referred them to the TIGTA Office of Investigations for review.

In that regard, I am pleased that the report found:

- that you did not identify any indications that EO inappropriately handled information items you reviewed, and you did not make any referrals to the TIGTA Office of Investigations;
- that the EO Referral Committee followed a consistent process when reviewing information items, regardless of the source of the allegation or the nature of the alleged political activity;

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- that you did not identify any cases in which the same criteria were used to select one information item for examination and to decline a similar item for examination; and
- that the information items EO selected and did not select for examination concerned organizations reflecting a variety of political views.

We are committed to enforcing the tax law that relates to tax-exempt organizations, including that portion of the tax law that restricts political intervention by 501(c)(3) organizations. The prohibited political activity program is but one aspect of this commitment, and was part of a larger effort that included both an educational and an enforcement component. We initiated our educational efforts well in advance of, and through, the 2004 election cycle. Our enforcement component involved the prohibited political activity program, which became more visible during the active part of the election cycle; that is when violations are likely to occur and when we are most likely to receive information items regarding potentially prohibited political activity by section 501(c)(3) organizations. Through both our educational and enforcement efforts, we were, and continue to be, equally committed to fulfilling our obligation to enforce the tax law without regard to partisan considerations or political direction.

I appreciate your insightful recommendations about actions we can take to improve the administration of our prohibited political activity program in future years. Furthermore, we are evaluating the program as it operated during the last election cycle. By the end of April, we expect to make a number of decisions on changes to the program for the next election cycle, beginning in 2006.

As we make these decisions, and when we begin to implement them, we will ensure that we fully address the problems you identified in the report. We therefore agree with your recommendations and indicate below how we intend to implement them. We do this, however, with the understanding that we may need to modify the manner in which we implement one or more recommendations depending on the changes we make to the program for the 2006 election cycle. We will keep you informed of any revisions to the way we implement any of the recommendations, should they become necessary.

Our response to your specific recommendations follows.

RECOMMENDATION 1

The Director, EO, should formalize the draft guidelines that detail how allegations of potential noncompliance with the tax law by tax exempt organizations should be classified.

Review of the Exempt Organizations Function Process for Reviewing Alleged Political Campaign Intervention by Tax Exempt Organizations

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CORRECTIVE ACTION

We have drafted, are circulating for approval, and will make effective procedures that, among other things, specify how allegations of potential noncompliance with the tax law by tax exempt organizations should be classified.

IMPLEMENTATION DATE

April 30, 2005.

RESPONSIBLE OFFICIAL

Director, EO.

CORRECTIVE ACTION MONITORING PLAN

This corrective action will be monitored in monthly operational reviews conducted with the Director, EO.

RECOMMENDATION 2

The Director, EO, should ensure time standards for accelerated case initiation (both classification and examination) are realistic for future election years based on available resources and priorities.

CORRECTIVE ACTION

We are drafting revised procedures for our prohibited political activity program for future election years. The procedures provide realistic timeframes, based on experience to date. These procedures will be evaluated as cases from the 2004 election cycle are closed, and additional data is collected. EO will revise the procedures further, if appropriate, and will disseminate revised procedures to the field by December 31, 2005, for the 2006 election cycle.

IMPLEMENTATION DATE

We will issue final procedures by December 31, 2005.

RESPONSIBLE OFFICIAL

Director, EO Examinations.

CORRECTIVE ACTION MONITORING PLAN

This corrective action will be monitored in bi-weekly conferences between the Director, EO and the Director, EO Examinations.

RECOMMENDATION 3

The Director, EO, should establish time standards for when potential political intervention allegations received in nonelection years should be evaluated for

Review of the Exempt Organizations Function Process for Reviewing Alleged Political Campaign Intervention by Tax Exempt Organizations

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examination potential and sent to the examination groups, rather than just assigned to an examiner as currently required.

CORRECTIVE ACTION

We have drafted and are implementing procedures establishing set periods within which we will (a) assign information items alleging potential political intervention in non-election years to a classifier, and (b) either send the item from classification to a group or determine that an examination is not warranted.

IMPLEMENTATION DATE

April 30, 2005.

RESPONSIBLE OFFICIAL

Director, EO Examinations.

CORRECTIVE ACTION MONITORING PLAN

This corrective action will be monitored in bi-weekly conferences between the Director, EO and the Director, EO Examinations.

RECOMMENDATION 4

The Director, EO, should ensure any future expedited review process is initiated early enough in an election year to ensure classification and examination actions are completed timely and consistently.

CORRECTIVE ACTION

We have drafted, and the Director, EO Examinations, is now considering, procedures for future election years that cover the start of the prohibited political activity program and ensure that the process is initiated early enough to allow classification and examination actions to be completed timely and consistently. We will issue these procedures by December 31, 2005, for the 2006 cycle.

IMPLEMENTATION DATE

December 31, 2005.

RESPONSIBLE OFFICIAL

Director, EO Examinations.

CORRECTIVE ACTION MONITORING PLAN

This corrective action will be monitored in bi-weekly conferences between the Director, EO and the Director, EO Examinations.

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RECOMMENDATION 5

The Commissioner, TE/GE, should issue a press release in future election years if allegations of potential noncompliance with the tax laws will be processed on an expedited basis, to increase public awareness of the expedited process.

CORRECTIVE ACTION

The Commissioner, TE/GE, has requested the Director, Communications and Liaison, TE/GE, to prepare a press release in future election years, for release in advance of the commencement of future prohibited political activity programs, advising the exempt organizations community that allegations of potential noncompliance with the tax law relating to political activity will be processed on an expedited basis. The Director, Communications and Liaison, TE/GE, has entered this assignment on his calendar system for 2006.

IMPLEMENTATION DATE

Completed.

RESPONSIBLE OFFICIAL

Commissioner, TE/GE.

CORRECTIVE ACTION MONITORING PLAN

No monitoring is required because the corrective action is completed.