Introduction

Thirty years ago, the Filer Commission conducted an extensive review of the regulation of charities, ultimately coming to the conclusion that the Internal Revenue Service (“IRS”) continued to be the logical place to house the oversight of tax-exempt organizations based on the sensible view that tax collection and exemption from tax are inextricably entwined.\(^1\) While factors, such as the historic insulation of the IRS from partisan influence, clearly influenced the Commission’s thinking, the final observation cementing the recommendation (and thereby avoiding confrontation with those organizations and individuals invested in the status quo of general benign neglect) was that the opportunity to improve oversight was being “seized with a fair degree of vigor” by the then newly-created Office of the Assistant Commissioner, Employee Plans and Exempt Organizations.\(^2\) The purpose of this paper is to evaluate that role and the explore some of the manifestations of that “vigor,” with a particular focus on organizations recognized as exempt under section 501(c)(3) of the Internal Revenue Code (“the Code”).\(^3\)

---

\(^2\) Id. at 2644.
\(^3\) All section references are to the Internal Revenue Code of 1986, as amended. All regulatory references are to the regulations promulgated under the Code.

\*Copyright © 2007 by Marcus S. Owens. All rights reserved.
Role of the IRS

In one sense, the role of the IRS is easily defined: to enforce the federal tax laws. The agency’s responsibilities and powers extend no further than the four corners of the Code. However, those responsibilities and powers do not include a general equitable directive to right wrongs, despite the breadth of matters touched by the Code. For purposes of tax administration relating to tax-exempt organizations, the relevant Code provisions direct the IRS to ascertain which organizations should be recognized as exempt from tax, to determine the extent to which contributions should be deductible as charitable contributions, and to identify which transactions engaged in by those organizations should be subject to income or excise taxes. In order to facilitate making those decisions, section 7805(a) of the Code gives the Treasury Department and the IRS authority to issue “all needful rules and regulations” for enforcement of the tax law. Correspondingly, section 6033(a) of the Code mandates the filing of returns and the maintenance of records, giving the Treasury and the IRS broad authority to design returns to collect information for “the purpose of carrying out the internal revenue laws.” Section 7602(a) of the Code authorizes the examination of such books and records as may be “relevant or material” to tax administration – essentially the ability to review the returns filed pursuant to section 6033(a) for accuracy. While the relevancy or materiality standard is a low threshold, it is a bar at some level. In contrast, the powers over charities accruing to a state attorney general by virtue of state statute or judicial decision regarding the appropriate use of

---

4 The language of Section 7601(a) is almost Biblical in style and tone: “The Secretary shall, to the extent he deems it practicable, cause officers or employees of the Treasury Department to proceed, from time to time, through each internal revenue district and inquire after and concerning all persons therein who may be liable to pay any internal revenue tax, and all persons owning or having the care and management of any objects with respect to which any tax is imposed.”

5 It seems obvious that a reference in the Code to a particular matter, even one with relevance to tax administration, does not authorize the IRS to promulgate and enforce rules governing any aspect of the matter. For example, I suspect that no one would argue that section 151(c) providing for dependents’ exemptions authorizes the IRS to regulate the actual number of dependents.

charitable funds are generally considered to be broader, at least in some respects.\textsuperscript{7} In view of the fact that both the flush language of the Code and summons enforcement court decisions (arguably, the place at which the enforcement power of the agency is starkest) link IRS authority to the needs of tax administration, it is natural to see the IRS authority regarding tax-exempt organizations as bounded by the requirements of that task, however it might be defined.

That simplistic approach to defining the role of the IRS, however, is misleading because of the breadth of the specific tax administration tasks set out in the Code relating to tax-exempt organizations, as clarified by Treasury Regulations and interpreted by judicial decisions. In the name of administering tax, the IRS has been thrust into the core operations of tax-exempt organizations. For example, section 501(c)(3) asks the IRS to evaluate the operations of charities to ascertain whether private individuals are deriving some impermissible benefit from association with the organizations or whether the charities serve any other substantial nonexempt purpose.\textsuperscript{8} The dimensions of that directive in section 501(c)(3) of the Code are stunningly broad: the IRS clearly has been charged with reviewing the entire array of a charity's operational and financial arrangements to assay the characteristics of the benefits derived from them and to weigh the substantiality of the organization's various purposes. The scope of the IRS authority to probe and evaluate (not necessarily remedy) is thus as great, perhaps greater, than that of a state attorney general, as section 7601(a) the Code contemplates IRS review without the prerequisite of suspicious action on the part of the charity. Furthermore, while the IRS does not normally have equitable powers of the charities it regulates, its ability to discipline by imposing income and excise taxes—assessed without the need for judicial action—often allow it to coerce compliance with its directives in order to avoid harsh financial

\textsuperscript{7} Attorneys General or other state regulators often have a broader scope of interest in charitable affairs, serving as the representatives of the public and empowered to ensure that charities' fundraising claims are accurate, that contributions are used for their stated purposes. In many cases, the IRS would have little interest in such matters, so long as the ultimate use were charitable. Attorneys General also generally can petition the courts for legal and equitable remedies against misbehaving fiduciaries such as injunctions, civil damages (payable to the charity) and removal.

\textsuperscript{8} Section 501(c)(3) of the Code.
sanctions. Furthermore, the requirements of the Code apply universally to domestic charities, regardless of where their activities occur, and to foreign charities that have sought recognition of U.S. federal income tax exemption. State lines, the boundaries of Indian reservations and federal enclaves, such as the District of Columbia, pose no impediment to IRS review. Nevertheless, while I would argue that IRS power, in the sense of the power to review, is omnipresent, it is not omnipotent nor is it omniscient.

The IRS power to review is bounded by the key element of the voluntary tax system: the tax return, and by its corollary, the tax year, which create a rhythm that governs IRS action. Congress has reinforced the concept of a tax return/tax year boundary by creating a few narrow exceptions to the rule. For example, in the context of a section 501(c)(3) organization, section 6852 of the Code provides for a termination assessment in the case of flagrant political campaign expenditures, but only if the “flagrancy” threshold is met. Mere political campaign intervention, stripped of the shocking or glaring characteristics inherent in the term “flagrant,” is not to be investigated or sanctioned until a tax return has been duly filed for the tax year in question, or the due date for such a return has passed. To assert otherwise would obviate the need for a special provision authorizing an imposed termination of a tax year on an organization. Accordingly, the IRS cannot react, using its customary enforcement powers, to transgressions of the Code’s rules for charities until the tax year implicated in the acts has closed, with the single narrow exception of flagrant, not just actual, political campaign intervention. Should this be the case? I would argue that so long as the tax system, with its powerful array of enforcement powers, is intact, the IRS can be relied upon to enforce the Code’s rules with due regard.

---

9 For example, the second-tier taxes of Chapter 42 generally impose confiscatory penalties on to those private foundations that fail to correct the Chapter 42 violation “voluntarily” within a prescribed period. While the IRS lacks an Attorney General’s power to seek an injunction correcting wrongdoing in court, few foundations would choose to forego correction when faced with a 100% or 200% tax on the amount involved for failure to do so.

10 The ability of the IRS to force access to a foreign charity’s books and records would be constrained by any tax treaties or other agreements in place between the U.S. and the foreign government, and by the laws and legal procedures of the foreign jurisdiction.

11 Section 6852(a)(2) of the Code provides that the IRS shall determine the taxes owed as if the tax year ended on the date on which the flagrant act of political campaign intervention occurred “as though such period were a taxable year of the organization.” Similarly, section 6851 of the Code authorizes the IRS to move to assess income tax if the agency “finds that a taxpayer designs quickly to depart from the United States or to remove his property therefrom” in order to defeat the collection of income taxes for “the current or the immediately preceding taxable year.”
tools that can be deployed without independent approval or oversight and its voluntary compliance ethos, is the vehicle for enforcement of the standards for behavior of charities, then a boundary established by tax return filing or the close of a tax year is a necessity.

The defective omniscience of the IRS is spawned by a combination of the previously noted breadth of the actual responsibilities of charity oversight under the Internal Revenue Code and the imbedding of the oversight in a tax system, dependent on tax return-based reporting and tied to concepts of numerical measurement of activities. Institutional behavior that is not easily reduced to numbers or imperfectly reflected in balance sheets and income statements is going to be incompletely reflected on a tax return. Timeliness of information is also an issue. In contrast to the reporting and disclosure demanded of publicly-traded corporations under securities laws, the annual information return, the Form 990, can be filed nearly 11 months after the close of the tax year, potentially approaching two years after the event in the case of transgressions occurring early in the tax year. The IRS thus is limited to systematically collecting historic data, data that is approaching staleness from an enforcement perspective. Given the tax return/tax year limitation on the IRS enforcement power, this information schedule is appropriate; it would make little sense for a tax-based oversight system to collect current information that it could not act upon until the following year. If more timely oversight is desired, it would be important to couple it with a less intrusive enforcement system that inserted an independent authority, such as a court or other independent review process, into the framework before taxes and other sanctions could be imposed in order to safeguard from abuse.

Tax Administration Tools: The Bully Pulpit

To carry out its role of tax administrator, the IRS has an array of enforcement tools at its disposal, including relatively passive informational devices. Perhaps one of the most important and efficient tools for the agency takes advantage of the power of the media and

---

12 In the interests of creating a more electronically friendly return, the recently released draft Form 990 for FY 2007 reflects an increasing focus on numerical reporting and reduced opportunity for narrative response.
the ethical obligations imposed on those professionals who practice before the IRS. By the very act of describing the minimum standards for tax compliance regarding a particular arrangement or transaction, the IRS co-opted an army of private sector attorneys and accountants to carry the message to taxpayers, including tax-exempt organizations, propelled by the ethical standards of the particular professions, backed by the powers of the IRS Director of Practice. The continuum of such tools begins with regulations, revenue rulings and revenue procedures that are vetted through several layers of personnel at the IRS and Treasury, and continues down through tax forms (with related instructions), plain language publications, news and information releases, Internal Revenue Manual (“IRM”) sections, official training materials, speeches and testimony, the annual “work plan,” also known as Implementing Guidelines, and, more recently, IRS website material. Closely related are the publicly-disclosed footprints of enforcement actions, such as technical advice memoranda, various counsel memoranda, and private letter rulings. On rare occasions, the IRS has even resorted to public hearings on draft positions, including revenue procedures and IRM provisions.  

Historically, the Exempt Organizations Division (“the Division” or “the EO Division”) has led the IRS as a whole in exploiting the Bully Pulpit. Partly in recognition of the sensitivity of many of the topics and organizations comprising the tax-exempt sector, and partly in recognition of the impact that public announcement of standards has, the Division was the first component of the IRS to make its annual examination plans public. The examination plans, variously referred to as Workplans or the Implementing Guidelines, were initially made public by simply placing a copy in the IRS Freedom of Information Reading Room at the Headquarters Building in Washington, DC. In more recent years, release of the document has been through a formal press release. 

One of the tasks of the Division has been to ensure that revenue agents and other frontline Agency personnel are aware of tax law developments that affect their areas of responsibility. In the past, the education function was accomplished through several days

---

13 In 1978 and 1979, the IRS released for public comment and held hearings on a draft revenue procedure providing guidance on private elementary and secondary schools and racial discrimination. Subsequently, the IRS released proposed IRM provisions for public comment, including examination guidelines on college and university examinations.
of lectures delivered to groups of agents in each key district office. From 1979 until 2004, in a pioneering effort for the IRS, the Division annually published a volume of essays on various tax topics, generally coordinated with the issues deemed significant in the annual examination plans, to serve as the text for the lectures. That text provided an opportunity for the Division to describe issues of concern with sufficient context to attempt to capture the nuance of the often sensitive and/or complex tax issues. As with the examination plans, the training texts were released to the public through the simple act of placing a copy in the IRS Freedom of Information Reading Room, as well as making copies available for distribution at the normal copying charge for FOIA documents.

In addition to the public release of generalized informational documents, the IRS is compelled to make public certain taxpayer-specific documents pursuant to section 6110 and section 6104 of the Code. The scope of documents subject to release under either provision has steadily grown over the years, generally in response to litigation by Tax Analysts, Inc., a tax information publishing organization. Without the insistence of Tax Analysts, the IRS has begun releasing “information letters,” essentially generalized discussions of a particular tax question submitted by a taxpayer. The responses do not bind the IRS to a particular outcome on a particular set of facts, but do reflect the Agency’s approach to the analysis of questions in a way that can be very helpful, particularly if circumstances make the issuance of a binding private letter ruling difficult.

Beginning approximately 2004, however, the Division seems to have shifted the nature and extent of the information it makes public. Training materials are no longer routinely made public, and the Continuing Professional Education Training Text that was published for 25 years appears to have been discontinued. The charities homepage on the IRS website contains a listing of “field memoranda” – essentially communications from the Division in Washington, DC, to field offices charged with taking enforcement actions, however, the IRS has only released eight such memoranda since 1999. At least one plain language publication, Publication 578, regarding private foundations, has been discontinued, apparently based on a cost/benefit analysis taking into account the relatively

---

small number of private foundations and the costs of maintaining a special publication for such a limited audience. The number of private letter rulings has been depressed by a combination of significantly increasing user fees\textsuperscript{16} and by the length of time that it takes to secure such a ruling. For those that are issued, the IRS has taken an expansive view of taxpayer-identifying information that must be redacted from the rulings before release to comport with the privacy rules in section 6103 of the Code. Even more significantly, the number of precedential guidance documents, such as revenue rulings, has declined. In the ten years after the passage of the Tax Reform Act of 1969, with its regime of excise taxes for private foundations, the IRS released detailed regulations and at least 18 revenue rulings defining and refining the concept of self-dealing under section 4941 of the Code. In the ten years since the Taxpayer Bill of Rights 2, which contained the excess benefit transactions excise tax on certain compensation and financial transactions between publicly supported charities certain insiders, the IRS has released regulations, but not a single revenue ruling.

Commendably, the Division has increased the production of pamphlets and documents summarizing aspects of federal tax law for a general, rather than a practitioner, audience. Additionally, the Division is making more frequent and creative use of its homepage on the IRS website, but again with an emphasis on the communication of very general discussions of the law. Information on the IRS website, however, is often undated and not assigned a document number, making it very difficult to verify whether the statements reflect current IRS views or not, and whether unapparent changes have been made to a particular discussion. The legal import of IRS website discussions is, at best, ambiguous, and should be clarified. Perhaps the IRS should give consideration to the systematic incorporation of its website discussions into the Internal Revenue Manual or treating them as explanatory publications with a date and document number so that the material is assimilated in an understandable way into the range of federal tax information materials.

\textsuperscript{16} Revenue Procedure 2007-8 sets the general user fee for a private letter ruling at $8,700.00.
Tax Administration Tools: The Big Stick

In addition to the more passive Bully Pulpit tax administration tools, in the tax-exempt organizations area, the IRS retains the full arsenal of aggressive enforcement tools, as well as several that are less frequently employed by other functions of the Agency. Examples of the latter include the determination program, which allows the Service to negotiate adjustments in structure or operation before approving an exemption application, and the recently developed “compliance check” process under which a questionnaire or similar survey document is mailed to a particular category of tax-exempt organization in order to ascertain patterns of behavior in the sector. The IRS takes the position that the compliance check does not rise to the level of an examination of the organization’s books and records and that there is no penalty for failure to respond. A failure to respond would, however, clearly be taken into consideration in determining whether additional action might be necessary. The compliance check tool enables the IRS to contact far more organizations in a year than traditional enforcement tools, including correspondence examinations. When focused on a discreet segment of the charitable sector, such as the recent survey of hospitals, the IRS is able to build a database of knowledge about institutional behavior in order to better inform guidance development and enforcement decisions.

Another evolutionary development in the Division’s approach to examinations, and, perhaps, the polar opposite of the compliance check, has been the formation of a “Financial Investigations Unit” composed of two revenue agent groups, 18 revenue agents in total, who have received specialized forensic accounting and financial training. The FIU agents undertake examinations of more complex and sensitive matters, and provide

---

17 The precursors of the compliance check process were the survey of charities in the wake of the Tax Reform Act of 1969 in order to classify them under the various categories of organizations described in section 509 of the Code and the surveys of Mississippi private schools undertaken by order of the District Court in various iterations of the Green v. Connally litigation. A recent example of the compliance check procedure is reflected in IRS News Release IR-2007-132 (July 19, 2007) describing the results from a survey of 500 tax-exempt hospitals.
technical tax-exempt organizations support to the IRS Criminal Investigation Division and other Agency units.

While the Division has been creative in developing efficient ways to interact with the charities, it has not been as creative in the use of the Code’s enforcement provisions as it could. For example, other functions of the IRS, including the Tax-Exempt Bonds Division and those functions dealing with taxable entities, have begun utilizing the tax shelter promotion penalties in sections 6700 and 6701 of the Code, and the Service’s ability to seek an injunction against further promotion of the tax shelter. The Exempt Organizations Division has not been unaware of the application of the penalties outside of the traditional tax shelter arena. For example, as early as 1999, the Exempt Organizations Division was conducting training on sections 6700 and 6701 for exempt organizations revenue agents.

In view of ability of the IRS to target all the participants in a particular transaction or relationship with the penalties, not just the tax-exempt organization involved, the penalty regime has potential for addressing the manipulative use of tax-exempt organizations by third parties. For example, it has been suggested that a creative utilization of the tax shelter penalties might be an effective way to deal with aspects of the use of charities for political campaign intervention purposes.

Oversight of the IRS

In view of the significant powers of the IRS with regard to reviewing the affairs of taxpayers, including tax-exempt organizations, the need for review and oversight of its operations is apparent. Periodic reviews are conducted by the Treasury Inspector General for Tax Administration (“TIGTA”) and the General Accountability Office (“GAO”). More infrequently, the Joint Committee on Taxation (“JCT”) has undertaken focused reviews of

---

discreet EO Division activities. In addition to the preceding, both the IRS Oversight Subcommittee of the House Ways & Means Committee and the Senate Finance Committee hold occasional Congressional hearings on tax-exempt organizations matters.

The nature of the reviews and the specialized expertise of the reviewers varies widely. For example, TIGTA reviews are conducted by internal auditors or special agents trained in criminal investigation and tend to focus on procedural matters; TIGTA does not employ investigators who have the training to evaluate the technical accuracy of the EO Division’s operations, only the extent to which those operations conform to IRS procedures. This limitation results in disclaimers such as the one included in the TIGTA review conducted after the IRS commenced an examination of the NAACP for political campaign intervention.\textsuperscript{21} Reviews conducted by the GAO generally suffer from a similar limitation, however, the GAO, on occasion, does consult with outside subject matter experts from time to time. The effectiveness of such consultations is open to question as the outside experts do not participate in the actual collection and analysis of the information because of the need to adhere to the privacy rules in section 6103. Reviews conducted by the JCT or the House and Senate Oversight Committees are typically conducted by attorneys with technical familiarity of the relevant Code provisions. Those sorts of reviews are relatively uncommon and usually narrowly focused. As a result, no general assessment of the technical correctness of the EO Division’s operations occurs; there is no regular and systematic review of determination or examination cases for technical accuracy by independent reviewers with sufficient training and experience to conduct a true evaluation.

Recommendation

\textsuperscript{21} \textit{Review of the Exempt Organizations Function Process for Reviewing Alleged Political Campaign Intervention by Tax Exempt Organizations} (Feb. 2005), Reference Number 2005-10-035. In her transmittal memorandum for the report, Pamela Gardiner, Deputy Inspector General for Audit, noted “we limited our audit to a review of the process followed by the EO function for reviewing the allegations and did not determine whether the activities by the tax-exempt organization involved potentially prohibited political activity.”
It is critical that the charitable sector, and the public in general, have confidence that the IRS is administering the tax laws correctly, including with acceptable levels of procedural and technical accuracy. While technical accuracy can be challenged through the courts, the significant expense of doing so is a considerable barrier for most tax-exempt organizations. Similarly, it is unlikely that either TIGTA or the GAO will have the funding to hire subject matter experts in as narrow a field as tax-exempt organizations tax law.

An alternative way for the Service to demonstrate the quality of at least a portion of its oversight efforts would be for the agency to periodically make public a sample of the administrative records of determination cases. Section 6104 already makes the completed application files a matter of public record, but the difficulty of obtaining copies from the IRS effectively prevents any systematic analysis of the files. If the EO Division, on some regular basis, selected a sample of its determination work for review by, for example, special committees of the Exempt Organizations Committees of the American Bar Association Tax Section and the AICPA, the public and the IRS would have a window into the technical quality of the Division’s decision making. Such a process would not require any legislative changes or require significant expenditures of IRS funds, but could provide considerable assurance that the IRS is administering the tax law properly.