HEARING BEFORE THE
COMMITTEE ON FINANCE
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"A REVIEW OF CRITERIA USED BY THE IRS TO IDENTIFY 501(C)(4) APPLICATIONS FOR GREATER SCRUTINY"

Testimony of
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May 21, 2013

Washington, D.C.

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OF
THE HONORABLE J. RUSSELL
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TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION
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Chairman Baucus, Ranking Member Hatch, and Members of the Committee, thank you for the invitation to provide testimony on the subject of the Internal Revenue Service's (IRS) processing of certain applications for tax-exempt status. The Treasury Inspector General for Tax Administration, also known as TIGTA, has provided ongoing oversight of the IRS's Tax Exempt and Government Entities Division, Exempt Organizations' (EO) customer service and compliance efforts, including those related to political activities. For example, several reviews have covered the IRS's political activities compliance initiative,[1] as well as the processing of political action committees' returns.[2] My testimony today focuses on the results of our most recently issued report.[3] In this report, TIGTA determined whether allegations were founded that the IRS: 1) targeted specific groups applying for tax-exempt status, 2) delayed processing targeted groups' applications for tax-exempt status, and 3) requested unnecessary information from targeted groups. Our report is included as an attachment to the testimony, and I will provide highlights of our key findings.

Organizations, such as Internal Revenue Code (I.R.C.) Section (§) 501(c)(3)[4] charities, seeking Federal tax exemption are required to file an application with the

[1] TIGTA, Ref. No. 2005-10-035, *Review of the Exempt Organizations Function Process for Reviewing Alleged Political Campaign Intervention By Tax-Exempt Organizations* (Feb. 2005);
TIGTA, Ref. No. 2008-10-117, *Improvements Have Been Made to Educate Tax-Exempt Organizations and Enforce the Prohibition Against Political Activities, but Further Improvements Are Possible* (June 2008).
[2] TIGTA, Ref. No. 2005-10-125, *Additional Actions Are Needed to Ensure Section 527 Political Organizations Publicly Disclose Their Actions Timely and Completely* (Aug. 2005);
TIGTA, Ref. No. 2010-10-018, *Improvements Have Been Made, but Additional Actions Could Ensure That Section 527 Political Organizations More Fully Disclose Financial Information* (Feb. 2010).
[3] TIGTA, Ref. No. 2013-10-053, *Inappropriate Criteria Were Used to Identify Tax-Exempt Applications for Review* (May 2013).
[4] I.R.C. § 501(c)(3) (2012).

IRS. Other organizations, such as I.R.C. § 501(c)(4)[5] social welfare organizations,[6] may file an application but are not required to do so. The IRS's EO function's Rulings and Agreements office, which is based in Washington, D.C., is responsible for processing applications for tax exemption. Within the Rulings and Agreements office, the Determinations Unit in Cincinnati, Ohio, is responsible for reviewing applications as they are received to determine whether the organization qualifies for tax-exempt status. If the Determinations Unit needs technical assistance[7] processing applications, it may call upon the Technical Unit in Washington, D.C., which is within the Rulings and Agreements office.

Most organizations requesting tax-exempt status must submit either a Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, or Form 1024, *Application for Recognition of Exemption Under Section 501(a)*,[8] depending on the type of tax-exempt organization.

The I.R.C. section under which an organization is granted tax-exempt status affects the activities it may undertake. For example, I.R.C. § 501(c)(3) charitable organizations are prohibited from directly or indirectly participating in or intervening in any political campaign on behalf of or in opposition to any candidate for public office (hereinafter referred to as political campaign intervention).[9] However, I.R.C. § 501(c)(4) social welfare organizations, I.R.C. § 501(c)(5)[10] agricultural and labor organizations,[11] and I.R.C. § 501(c)(6)[12] business leagues[13] may engage in limited political campaign intervention.

The IRS receives thousands of applications for tax-exempt status annually. Between fiscal years 2009 and 2012, the IRS received approximately 60,000-65,000

[5] I.R.C. § 501(c)(4) (2012).
[6] Organizations that promote social welfare primarily promote the common good and general welfare of the people of the community as a whole, such as a nonprofit organizations providing financial counseling, youth sports, and public safety.
[7] Assistance such as interpretation of the tax law or guidance on issues that are not covered by clearly established precedent.
[8] Form 1024 is used by organizations seeking tax-exempt status under a number of other I.R.C. sections, including I.R.C. § 501(c)(4) social welfare organizations, I.R.C. § 501(c)(5) agricultural and labor organizations, and I.R.C. § 501(c)(6) business leagues.
[9] Political campaign intervention is the term used in Treasury Regulations §§ 1.501(c)(3)-1, 1.501(c)(4)-1, 1.501(c)(5)-1, and 1.501(c)(6)-1. I.R.C. § 501(c)(3) defines political campaign intervention as directly or indirectly participating in or intervening in any political campaign on behalf of or in opposition to any candidate for public office.
[10] I.R.C. § 501(c)(5) (2012).
[11] Agricultural organizations promote the interests of persons engaged in raising livestock or harvesting crops, and labor organizations include labor unions and collective bargaining associations.
[12] I.R.C. § 501(c)(6) (2012).
[13] Nonprofit organizations such as chambers of commerce, real estate boards, and boards of trade that promote the improvement of business conditions.

applications for I.R.C. § 501(c)(3) status each year. In addition, receipts for I.R.C. § 501(c)(4) applications increased between fiscal years 2009 and 2012 from approximately 1,700 to more than 3,300 annually.

During the 2012 election cycle, some Members of Congress raised concerns to the IRS about its selective enforcement efforts and reemphasized its duty to treat similarly situated organizations consistently. In addition, several organizations applying for I.R.C. § 501(c)(4) tax-exempt status made allegations that the IRS: 1) targeted specific groups applying for tax-exempt status, 2) delayed the processing of targeted groups' applications for tax-exempt status, and 3) requested unnecessary information from targeted organizations. Lastly, several Members of Congress requested that the IRS investigate whether existing social welfare organizations are improperly engaged in a substantial, or even predominant, amount of campaign activity.[14]

We initiated this audit based on concerns expressed by Congress and reported in the media regarding the IRS's treatment of organizations applying for tax-exempt status. We focused our efforts on reviewing the processing of applications for tax-exempt status and determining whether allegations made against the IRS were founded. Over 600 tax-exempt application case files were reviewed by TIGTA. We did not review whether specific applications for tax-exempt status should be approved or denied. We also did not review any IRS examinations of tax-exempt organizations in this audit.

Results of Review

In summary, we found that all three allegations were substantiated. The IRS used inappropriate criteria that identified for review Tea Party and other organizations applying for tax-exempt status based upon their names or policy positions instead of indications of potential political campaign intervention. Because of ineffective management by IRS officials: 1) inappropriate criteria were developed and stayed in place for a total of more than 18 months, 2) there were substantial delays in processing certain applications, and 3) unnecessary information requests were issued to the organizations.

Inappropriate Criteria Were Used to Identify Potential Political Cases

The IRS developed and began using criteria to identify tax-exempt applications for review by a team of specialists that inappropriately identified specific groups applying for tax-exempt status based on their names or policy positions, instead of developing

[14] A second audit is planned to assess how the EO function monitors I.R.C. §§ 501(c)(4)–(6) organizations to ensure that political campaign intervention does not constitute their primary activity.

criteria based on tax-exempt laws and Treasury Regulations. The criteria evolved during 2010.

- In early Calendar Year 2010, according to an IRS Determinations Unit specialist, the IRS began searching for applications with "Tea Party," "Patriots," or "9/12" in the organization's name as well as other "political-sounding" names (hereinafter referred to as potential political cases).
- In May 2010, a Determinations Unit specialist and group manager began developing a spreadsheet that would become known as the "Be On the Look Out" listing (hereinafter referred to as the "BOLO" listing), which included the emerging issue of Tea Party applications.
- In June 2010, Determinations Unit managers and specialists began training Determinations Unit specialists on issues to be aware of, including Tea Party cases.
- By July 2010, Determinations Unit management stated that it had requested its specialists to be on the lookout for Tea Party applications.

In August 2010, the Determinations Unit distributed the first formal BOLO listing. The criteria in the BOLO listing were stated as "Tea Party organizations" applying for I.R.C. § 501(c)(3) or I.R.C. § 501(c)(4) status.

EO function officials in Washington, D.C. stated that Determinations Unit specialists interpreted the general criteria in the BOLO listing and developed expanded criteria for identifying potential political cases. By June 2011, these criteria included:

"Tea Party," "Patriots" or "9/12 Project" is referenced in the case file
Issues include government spending, government debt or taxes
Education of the public by advocacy/lobbying to "make America a better place to live"
Statements in the case file criticize how the country is being run

The Director, EO, stated that the expanded criteria were a compilation of various Determinations Unit specialists' responses on how they were identifying Tea Party cases. We asked the Acting Commissioner, Tax Exempt and Government Entities Division; the Director, EO; and Determinations Unit personnel if the criteria were influenced by any individual or organization outside the IRS. All of these officials stated that the criteria were not influenced by any individual or organization outside the IRS. Instead, the Determinations Unit developed and implemented inappropriate criteria due to insufficient oversight provided by management and other human capital challenges.

Specifically, first-line management in Cincinnati, Ohio approved references to the Tea Party in the BOLO listing criteria. As a result, inappropriate criteria remained in place for more than 18 months.[15] Determinations Unit managers and employees also did not consider the public perception of using these criteria when identifying these cases. Moreover, the criteria developed showed that the Determinations Unit specialists lacked knowledge of what activities are allowed by I.R.C. § 501(c)(3) and I.R.C. § 501(c)(4) organizations.

However, developing and using criteria that focus on organization names and policy positions instead of the activities permitted under the Treasury Regulations does not promote public confidence that tax-exempt laws are being applied impartially. The IRS's actions regarding the use of inappropriate criteria over such an extended period of time has brought into question whether the IRS has treated all taxpayers fairly, which is an essential part of its mission statement.[16]

After being briefed on the expanded criteria in June 2011, the Director, EO, immediately directed that the criteria be changed. In July 2011, the criteria were changed to focus on the potential "political, lobbying, or advocacy" activities of the organization and references to these cases were changed from "Tea Party cases" to "advocacy cases." These criteria were an improvement over using organization names and policy positions because they were more consistent with tax-exempt laws and Treasury Regulations.

However, the team of Determinations Unit specialists subsequently changed the criteria in January 2012 without senior IRS official approval because they believed the July 2011 criteria were too broad. The January 2012 criteria again focused on the policy positions of organizations, instead of tax-exempt laws and Treasury Regulations. After three months, the Director, Rulings and Agreements, in Washington, D.C. learned the criteria had been changed by the team of specialists and subsequently revised the criteria again in May 2012. The May 2012 criteria more clearly focus on activities permitted under the Treasury Regulations. We are not aware of any additional changes to the criteria during our audit. We are continuing to look into whether any violations of

[15] The 18 months were not consecutive. There were two different time periods when the criteria were inappropriate (May 2010 to July 2011 and January 2012 to May 2012).
[16] The IRS's mission is to provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.

the Internal Revenue Service Restructuring and Reform Act of 1998[17] (RRA 98) have occurred and if any political influence caused the change in criteria.[18]

Potential Political Cases Experienced Significant Processing Delays

The organizations that applied for tax-exempt status and that had their applications forwarded to the team of specialists for additional review experienced substantial delays. As of December 17, 2012, many organizations had not received an approval or denial letter for more than two years after they submitted their applications. Some cases have been open during two election cycles (2010 and 2012).

Potential political cases took significantly longer than average to process due to ineffective management oversight. Once cases were initially identified for processing by the team of specialists in February 2010, the Determinations Unit Program Manager requested assistance via e-mail from the Technical Unit to ensure consistency in processing the cases. However, the Determinations Unit waited more than 20 months (February 2010 to November 2011) to receive draft written guidance from the Technical Unit for processing potential political cases.

The team of specialists stopped working on potential political cases from October 2010 through November 2011, resulting in a 13-month delay, while they waited for assistance from the Technical Unit. Many organizations waited much longer than 13 months for a decision while others have yet to receive a decision from the IRS. For example, as of December 17, 2012, the IRS had been processing several potential political cases for more than 1,000 calendar days (approximately 3 years). Some of these organizations received requests for additional information in Calendar Year 2010 and then did not hear from the IRS again for more than a year while the Determinations Unit waited for assistance from the Technical Unit. For the 296 potential political cases we reviewed, as of December 17, 2012, 108 applications had been approved, 28 were withdrawn by the applicant, none had been denied, and 160 cases were open from 206 to 1,138 calendar days (some crossing two election cycles).

[17] Pub. L. No. 105-206, 112 Stat. 685. 1998 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

[18] It is a violation of RRA 98 § 1203(b)(3) for IRS employees to falsify or destroy documents to conceal mistakes made by any employee with respect to a matter involving a taxpayer or taxpayer representative and a violation of RRA 98 § 1203(b)(6) for IRS employees to violate the Internal Revenue Code, Treasury Regulations, or policies of the IRS for purposes of retaliating against or harassing a taxpayer. Proven violations of Section 1203 require the termination of the offending IRS employee.

The IRS Requested Unnecessary Information for Many Potential Political Cases

After receiving draft guidance in November 2011 from the Technical Unit on processing potential political cases, a different team of specialists in the Determinations Unit began sending requests for additional information in January 2012 to organizations that were applying for tax-exempt status. For some organizations, this was the second letter received from the IRS requesting additional information, the first of which had been received more than a year before this date. These letters requested that the information be provided in two or three weeks (as is customary in these letters) despite the fact that the IRS had done nothing with some of the applications for more than one year. After the letters were received, organizations seeking tax-exempt status, as well as Members of Congress, expressed concerns about the type and extent of questions being asked.

After this media attention, the Director, EO, stopped issuance of additional information request letters and provided an extension of time to respond to previously issued letters. EO function headquarters Washington, D.C. office employees reviewed the additional information request letters prepared by the team of specialists and identified seven questions that they deemed unnecessary, including requests for donor information, position on issues, and whether officers have run for public office. Subsequently, the EO function instituted the practice that all additional information request letters for potential political cases be reviewed by the EO function headquarters office before they are sent to organizations seeking tax-exempt status. In addition, EO function officials informed us that they decided to destroy all donor lists that had been sent in for potential political cases which the IRS determined it should not have requested.

The Determinations Unit requested unnecessary information because of a lack of managerial review, at all levels, of these information requests before they were sent to organizations seeking tax-exempt status. Additionally, as mentioned earlier, we concluded that Determinations Unit specialists lacked knowledge of what activities are allowed by I.R.C. § 501(c)(3) and I.R.C. § 501(c)(4) tax-exempt organizations. In May 2012, a two-day workshop was provided to the team of specialists to train them on what activities are allowable by I.R.C. § 501(c)(4) organizations, including lobbying and political campaign intervention.

IRS's Response to Our Recommendations

TIGTA made nine recommendations to provide more assurance that applications are processed in a fair and impartial manner in the future without unreasonable delay. The IRS agreed to seven of our nine recommendations and proposed alternative

corrective actions for two of our recommendations. However, we do not agree that the alternative corrective actions will accomplish the intent of the recommendations. One of these recommendations was that the IRS should clearly document the reason applications are chosen for further review for potential political campaign intervention. The second was that the IRS should develop specific guidance for specialists processing potential political cases and publish the guidance on the Internet. Further, the IRS's response also states that issues discussed in the report have been resolved. We disagree with this assertion. Until all of our recommendations are fully implemented and the numerous applications that were open as of December 2012 are closed, we do not consider the concerns in this report to be resolved. In addition, as part of our mission, TIGTA will also determine whether any criminal activity or administrative misconduct occurred during this process. The attached TIGTA report includes additional information on all nine recommendations and the IRS's planned corrective actions and completion dates.

We at TIGTA are committed to delivering our mission of ensuring an effective and efficient tax administration system and preventing, detecting, and deterring waste, fraud, and abuse. As such, we plan to provide continuing audit and investigative coverage of the IRS's efforts to administer the tax-exempt laws.

Chairman Baucus, Ranking Member Hatch, and Members of the Committee, thank you for the opportunity to update you on our work on this tax administration issue and to share my views.

J. Russell George
Treasury Inspector General for Tax Administration

Following his nomination by President George W. Bush, the United States Senate confirmed J. Russell George in November 2004, as the Treasury Inspector General for Tax Administration. Prior to assuming this role, Mr. George served as the Inspector General of the Corporation for National and Community Service, having been nominated to that position by President Bush and confirmed by the Senate in 2002.

A native of New York City, where he attended public schools, including Brooklyn Technical High School, Mr. George received his Bachelor of Arts degree from Howard University in Washington, D.C., and his Doctorate of Jurisprudence from Harvard University's School of Law in Cambridge, MA. After receiving his law degree, he returned to New York and served as a prosecutor in the Queens County District Attorney's Office.

Following his work as a prosecutor, Mr. George joined the Counsel's Office in the White House Office of Management and Budget where he was Assistant General Counsel. In that capacity, he provided legal guidance on issues concerning presidential and executive branch authority. He was next invited to join the White House Staff as the Associate Director for Policy in the Office of National Service. It was there that he implemented the legislation establishing the Commission for National and Community Service, the precursor to the Corporation for National and Community Service. He then returned to New York and practiced law at Kramer, Levin, Naftalis, Nessen, Kamin & Frankel.

In 1995, Mr. George returned to Washington and joined the staff of the Committee on Government Reform and Oversight and served as the Staff Director and Chief Counsel of the Government Management, Information and Technology subcommittee (later renamed the Subcommittee on Government Efficiency, Financial Management and Intergovernmental Relations), chaired by Representative Stephen Horn. There he directed a staff that conducted over 200 hearings on legislative and oversight issues pertaining to Federal Government management practices, including procurement policies, the disposition of government-controlled information, the performance of chief financial officers and inspectors general, and the Government's use of technology. He continued in that position until his appointment by President Bush in 2002.

In addition to his duties as the Inspector General for Tax Administration, Mr. George serves as a member of the Recovery Accountability and Transparency Board, a non-partisan, non-political agency created by the American Recovery and Reinvestment Act of 2009 to provide unprecedented transparency and to detect and prevent fraud, waste, and mismanagement of Recovery funds. There, he serves as chairman of the Recovery.gov committee, which oversees the dissemination of accurate and timely data about Recovery funds.

Mr. George also serves as a member of the Integrity Committee of the Council of Inspectors General for Integrity and Efficiency (CIGIE). CIGIE is an independent entity within the executive branch statutorily established by the Inspector General Act, as amended, to address integrity, economy, and effectiveness issues that transcend individual Government agencies; and increase the professionalism and effectiveness of personnel by developing policies, standards, and approaches to aid in the establishment of a well-trained and highly skilled workforce in the offices of the Inspectors General. The CIGIE Integrity committee serves as an independent review and investigative mechanism for allegations of wrongdoing brought against Inspectors General.