

**WRITTEN TESTIMONY OF
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BEFORE THE
SENATE FINANCE COMMITTEE
ON THE IRS'S RESPONSE TO THE COMMITTEE REPORT ON THE
PROCESSING OF APPLICATIONS FOR TAX-EXEMPT STATUS
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INTRODUCTION

Chairman Hatch, Ranking Member Wyden and Members of the Committee, thank you for the opportunity to discuss the IRS's response to the Committee's report on its investigation into the processing of applications for tax-exempt status under section 501(c) of the Internal Revenue Code. The Committee's investigation followed a report issued in May 2013 by the Treasury Inspector General for Tax Administration (TIGTA) on the IRS's use of improper criteria in the determination process for 501(c)(4) applications.

Let me begin by reiterating what I have said earlier in my tenure as IRS Commissioner. The situation described in the Inspector General's 2013 report should never have happened, and the IRS is doing everything possible to ensure that the mistakes referenced in the Inspector General's report do not happen again. Every taxpayer, whether an individual or an organization, needs to be confident that they will be treated fairly by the IRS, no matter what their political affiliation, their position on contentious political issues, or whom they supported in the last election.

Even with our declining resources, we will still audit over 1 million taxpayers this year. And when someone hears from us regarding their tax return – by letter, I should add, in light of the recent proliferation of IRS impersonation telephone scams – they need to understand that it is only because of something that is or should be in their tax return, and not other factors. And, if someone else has the same issue in regard to their return, they will hear from us as well, within the limits of our budget resources.

A shared belief in the fairness of our tax system and its administration is fundamental to the voluntary compliance by our citizens with the requirements of our tax laws. This compliance provides the vast majority of the over \$3 trillion in revenue that we collect for the nation every year. We are the stewards of this system and take our responsibility seriously.

As part of our work to move forward, we have implemented all of the recommendations made by the Inspector General in his May 2013 report. The changes we made in response to those recommendations include: eliminating the use of inappropriate criteria; expediting the processing of section 501(c)(4) applications; establishing a new process for documenting the reasons why applications are chosen for further review; developing guidelines for specialists in the IRS's Exempt Organizations (EO) division on how to process requests for tax-exempt status involving organizations engaging in potentially significant political campaign intervention; and creating a formal, documented process for EO determinations personnel to request assistance from technical experts. EO is committed to providing annual training for employees on political campaign intervention.

The Inspector General reviewed our actions and issued a follow-up report in March of this year, noting that the IRS had taken "significant actions" to address his recommendations.

RESPONDING TO THE COMMITTEE REPORT

We appreciate the enormous amount of hard work done and time spent by the Committee and its staff in investigating this matter and developing the report that is the subject of today's hearing. By its thorough and detailed nature, the Committee's report provides a full account of the IRS's section 501(c)(4) processing issues.

It is important to note that the IRS cooperated fully with the Committee's investigation and the investigations conducted by other Congressional committees, the Inspector General and the Department of Justice. Our efforts resulted in the production of more than 1.3 million pages of unredacted documents to this Committee and the House Ways and Means Committee, including approximately 80,000 emails sent or received by former Director of Exempt Organizations Lois Lerner. More than 250 IRS employees spent more than 160,000 hours working directly on complying with the investigations, at a cost to the agency of approximately \$20 million.

I am pleased to report, as I advised the Chairman and the Ranking Member by letter earlier, that the IRS has accepted all the recommendations in the Committee's report that are within our control – those that did not involve tax policy matters or legislative action. They include 15 of the report's 18 bipartisan recommendations and also six of the recommendations in the separate sections prepared by the Majority and Minority. I have attached a copy of my letter to this testimony for inclusion in the record.

The IRS has already made significant progress in implementing the Committee's recommendations within our control. In part, this is because a number of the Committee's recommendations overlap with the recommendations of the May

2013 Inspector General's report noted above. In addition, we have been working diligently over the last three months to implement those recommendations made by the Committee that do not overlap with those of the Inspector General.

IMPROVING PROCESSES IN THE EXEMPT ORGANIZATIONS AREA

Following is an overview of the significant actions that we have already taken or are taking in response to the Committee's recommendations. For the sake of brevity, we have grouped our actions into 10 broad categories that reflect the Committee's major concerns in relation to the processing of applications for tax-exempt status. The categories are as follows:

Promoting Transparency and Accessibility in the Exempt Organizations Determination Process. The IRS has taken a number of actions to ensure that the determination process for organizations applying for tax-exempt status is transparent, and that the public can easily obtain information on our procedures. For example, since the release of the Inspector General's May 2013 report, EO has made significant progress in facilitating public access to relevant materials through substantive updates to the Internal Revenue Manual (IRM) sections and revenue procedures that relate to the application process. These resources continue to be available to the public via the IRS website, IRS.gov. Moving forward, EO will review the instructions for the IRS forms that organizations use when applying for tax-exempt status, and will add references to the resources available on IRS.gov as needed.

Streamlining the Exempt Organizations Determination Process to Ensure Timely Processing and Reduce Delay. EO is committed to processing applications for tax-exempt status in a timely manner and resolving all determination cases within 270 days as recommended by the Committee. The IRS has taken a number of actions since the beginning of the Committee's investigation that have been designed to reduce processing times and eliminate any backlog. For example, in 2014 EO began tracking cases once they became 90 days old to ensure that potential barriers to resolution were addressed early on. This action and others complemented measures already adopted in response to the Inspector General's 2013 report, including the "Optional Expedited Process" for 501(c)(4) organizations with potential political campaign intervention activities. As a result of our actions, the average age of the application inventory has been significantly reduced. From April 2014 to July 2015, applications submitted on Forms 1023 – which are used by organizations applying for 501(c)(3) status and make up the majority of the EO application inventory – dropped from an average age of 256 days to 107 days. Applications submitted on Forms 1024 – which are used by organizations applying for tax-exempt status under section 501(c)(4) and other Code sections – went from an average age of 256 days to 112 days. The IRS will continue its efforts to further reduce any over-age inventory among applications for tax-exempt status.

Realigning Organizational Functions for Improved Service. One of the concerns raised in the Committee's report in regard to the management problems at the IRS in 2013 involved the decentralization of EO leadership and employees. The IRS has made several notable structural changes to enable performance improvements. For example, the positions of EO Director and EO Director of Rulings and Agreements were relocated from Washington, D.C. to Cincinnati, Ohio, so the EO leadership is now located with most EO employees who process applications for tax-exempt status. Additionally, the Tax Exempt/Government Entities Division (TE/GE) worked closely with the Office of Chief Counsel to move functions performing legal analysis from TE/GE to Chief Counsel. As a result, there is now a clear separation of duties, as well as well-defined procedures and improved lines of communication between TE/GE leaders and their counterparts in the Office of Chief Counsel.

Fostering a Culture of Accountability. The IRS has taken a number of steps to ensure that TE/GE employees, managers and leadership operate in an environment of accountability in regard to the processing of applications for tax-exempt status. For example, all TE/GE managers are now required to conduct regular workload reviews with their employees. In addition, the results of these reviews are shared with the senior leadership of each function, and the TE/GE Commissioner holds monthly Operational Reviews with each functional director. Information on the amount of time it takes to process cases is provided on a regular basis up the management chain, not only to TE/GE leadership but also to the IRS Commissioner and the Deputy Commissioner for Services and Enforcement. We believe this focus on case processing oversight directly contributes to, and ensures, improved processing times and reduced inventory. I would also note that the entire leadership chain of command, starting with the Commissioner's office and running down to the Director of Exempt Organizations and her direct reports, was replaced over two years ago.

Strengthening Risk Management through Improved Communication. The IRS has worked to ensure risks are managed more effectively throughout the organization, and within TE/GE in particular. In 2014, the IRS established an agency-wide enterprise risk management program, creating risk management liaisons in each area of our operations and providing for the regular identification and analysis of risks to be eliminated or managed across the agency. We are working to create a culture where employees are encouraged to think of themselves as risk managers and to report any issues or problems that occur. We are encouraging the further flow of information from front-line employees up through the organization as well as out to the front line from senior managers. As part of this program, TE/GE and the other IRS business divisions each established a new Risk Management Process to enable certain issues to be elevated to the executive leadership for review and discussion. This new and expansive process further mitigates the risk that sensitive issues may not be elevated in a timely manner.

Bolstering Employee Training. In response to the Inspector General's 2013 report, EO began developing new training and workshops for employees on a number of critical issues connected with the application process for tax-exempt status, including the difference between issue advocacy and political campaign intervention, and the proper way, under current law, to identify applications that require review of potentially significant political campaign intervention. EO is continuing to develop new ways of delivering and sharing training materials and technical expertise. For example, to respond to the Committee's interest in this area, EO conducted training this fall for determination specialists on quality standards, including standards for timely case processing. TE/GE is also implementing a "knowledge management" network which, when completed, will provide TE/GE employees with easy access to information on a wide range of technical issues, such as those involving unrelated business income tax, private foundations and employee plans.

Ensuring Neutral Review Processes. The IRS has taken a number of actions to ensure that a neutral review process exists for organizations applying for tax-exempt status. For example, in response to the Inspector General's 2013 report, the IRS provided guidance to EO employees on the proper way to process applications for tax-exempt status when an organization does not provide the IRS with sufficient information to reach a conclusion about the application. In 2014, the IRS implemented new procedures to ensure that requests for additional information in cases involving potential political campaign intervention activities are appropriate in scope and scale. These include the development of a template letter, Letter 1312, "Request for Additional Information," to better standardize such requests. In addition, the Department of the Treasury and the IRS are in the process of developing guidance on social welfare and non-social welfare activities of 501(c)(4) organizations. Our efforts to develop this guidance have been greatly informed by the more than 160,000 public comments received in response to the 2013 proposed regulations. We asked for, and received, comments on several issues, including three major ones: the proposed definition of political campaign activity; to which organizations that definition should apply; and the amount of political activity an organization can engage in consistent with a particular tax-exempt status. Our goal is to provide guidance that is clear, fair to everyone, and easy to administer. I am attaching for the record a summary of the comments received on these three major issues.

Improving Procedures under the Freedom of Information Act. The IRS is taking several actions in response to the concern expressed by the Committee in its report that IRS employees did not properly respond to certain FOIA requests, including requests regarding groups applying for tax-exempt status. To ensure that employees responsible for responding to FOIA requests have the tools they need to conduct robust searches for such requests, which are increasingly complex in scope and volume, the IRS's Disclosure Office is preparing guidance in the form of written standard search procedures. This guidance will focus on many of the more frequently requested categories of information, and will include

contact lists. Employees processing FOIA requests will be trained in those procedures by the end of 2015. Additionally, EO in May 2015 released new procedures for handling FOIA requests involving the Exempt Organizations area, which will help ensure searches are appropriately conducted across all components of the EO function, as recommended by the Committee.

Reviewing the Use of the Office Communicator System. In its report, the Committee raised important questions about records retention, as well as questions regarding IRS employees' use of the Office Communicator System (OCS). Similar to an internal instant messaging system, OCS enables IRS employees to hold virtual meetings and virtual training events involving large numbers of employees and offices. Employees also use OCS as an informal means of communication. Currently, the IRM advises employees who create Federal records using informal means of documentation or communication, including OCS, to convert those records to a more structured format to facilitate records management and enable appropriate retention. The IRS is working with the National Archives and Records Administration (NARA) on these issues and plans to improve this guidance by adding more specific instructions and clarifying examples.

Responding to Government Accountability Office (GAO)

Recommendations. In June 2015, the GAO released a report on the criteria the IRS uses to select exempt organizations for audit. In this report, the GAO found no evidence of organizations being selected in an unfair or biased manner. At the same time, the GAO also identified areas where EO's system of internal controls for the audit selection process could be improved in order to reduce the risk of returns being selected for audit in an unfair or biased manner. When the report was released, the IRS agreed with the GAO's recommendations, and stated that it was in the process of implementing them. The Committee has also recommended that the IRS implement the GAO's recommendations, and we are continuing to do so, tightening the internal controls for the audit selection process.

ENHANCING RECORDS RETENTION PROCEDURES

The investigations into the determination process for tax-exempt status also raised another issue that we have been working to address, and that is the need to ensure that electronic media containing important records are preserved and protected. This issue was brought into focus with the Inspector General's release of a report on June 30, 2015, on the IRS's production of emails relevant to the investigations by the Committee, the Inspector General and others into the issues surrounding the processing of applications for tax-exempt status.

The Inspector General's June 2015 report described difficulties encountered in searching for emails and retrieving them from the IRS's outdated system for electronic records retention. This included the erasure in March 2014 of 422

disaster recovery tapes associated with a decommissioned IRS email server, which occurred despite instructions issued to agency employees in May 2013 to preserve these types of records.

The Inspector General's June 2015 report stated the IG had uncovered "no evidence that the IRS employees involved intended to destroy data on the tapes or hard drives in order to keep this information from the Congress, the DOJ or TIGTA." Nonetheless, the IRS's failure to ensure employees followed the document preservation instructions is clearly unacceptable.

With the benefit of the Inspector General's report, the IRS has been making significant progress in implementing records management improvements. Specifically, we have initiated a process to secure the email records of all senior officials in the agency, including having all files archived to the network rather than relying on individual hard drives. We are also implementing records management improvements based on recommendations from NARA.

Additionally, we have worked to increase training of front-line information technology (IT) employees on document preservation issues, to exert greater control over the management of our email server backups, and to continue the preservation of all disaster recovery tapes. Collectively, these steps have helped the IRS create better policies and procedures to minimize the risk of future data loss incidents.

ADDRESSING OTHER CRITICAL TAX ADMINISTRATION ISSUES

While the IRS is working to complete the implementation of the Committee's recommendations in regard to the processing of applications for tax-exempt status, we also appreciate the bipartisan efforts being made by the Committee on other issues critical to taxpayers and tax administration.

One important issue involves pending legislation to extend a group of tax provisions that expired at the end of 2014. The uncertainty we face over the timing of the extenders legislation raises operational and compliance risks for the IRS's delivery of the upcoming tax filing season beginning in January and for everyone involved in tax administration. We are grateful for the Committee's efforts to ensure that Congress makes a decision, one way or another, on this legislation in a timely manner.

If the uncertainty over this legislation persists into December, the IRS could be forced to postpone the opening of the 2016 filing season. This would delay the start of processing of tax refunds for millions of taxpayers. In order to ensure there are no disruptions to the upcoming filing season, we believe it is critical for Congress to make a decision on the extenders legislation no later than the end of November. It will also be important to know whether any such legislation will be passed with or without substantive changes to the tax provisions. Minimal

changes to the provisions will simplify changes to IRS systems and aid the IRS in starting the tax filing season on time.

In addition to its efforts on tax extenders, the Committee has also been considering identity theft legislation. This legislation contains a number of provisions that would assist the IRS in its fight against stolen identity refund fraud and also improve tax administration generally. They include:

- ***Acceleration of information return filing due dates.*** Under current law, most information returns, including Forms 1099 and 1098, must be filed with the IRS by February 28 of the year following the year for which the information is being reported, while Form W-2 must be filed with the Social Security Administration (SSA) by the last day of February. The due date for filing information returns with the IRS or SSA is generally extended until March 31 if the returns are filed electronically. The proposed legislation would require these information returns to be filed earlier, which would assist the IRS in identifying fraudulent returns and reduce refund fraud, including refund fraud related to identity theft.
- ***Authority to require minimum qualifications for return preparers.*** The proposed legislation would provide the agency with explicit authority to require all paid preparers to have a minimum knowledge of the tax code. Requiring all paid preparers to keep up with changes in the Code would help promote high quality services from tax return preparers, improve voluntary compliance, and foster taxpayer confidence in the fairness of the tax system. It would help the IRS to focus resources on the truly fraudulent returns.
- ***Expanded access to National Directory of New Hires.*** Under current law, the IRS is permitted to access the Department of Health and Human Services' National Directory of New Hires for purposes of enforcing the Earned Income Tax Credit and verifying employment reported on a tax return. The proposed legislation would allow IRS access to the directory for broader tax administration purposes, which would assist the agency in preventing stolen identity refund fraud.
- ***Masking Social Security Numbers (SSN).*** Under current law, the Form W-2 furnished to an employee must include the employee's SSN. The proposed legislation would allow truncated SSNs on the copy of the Form W-2 furnished to employees. This change would make it more difficult for identity thieves to steal SSNs.
- ***Streamlined critical pay authority.*** The IRS Restructuring and Reform Act of 1998 increased the IRS's ability to recruit and retain a small number of key executive-level staff by providing the agency with streamlined critical pay authority. This allowed the IRS, with approval from Treasury, to

hire well-qualified individuals to fill positions deemed critical to the agency's success in areas such as international tax, IT, cybersecurity, online services and analytics support. This authority, which ran effectively for 14 years, expired at the end of Fiscal Year (FY) 2013. The loss of streamlined critical pay authority has created major challenges to our ability to retain employees with the necessary high-caliber expertise in the areas mentioned above. The proposed legislation would reinstate this authority.

The IRS has also discussed with the Committee a number of other proposals that would improve tax administration, and I encourage the Committee to approve these provisions as well. They include:

- **Correctible error authority.** The IRS has authority in limited circumstances to identify certain computation mistakes or other irregularities on returns and automatically adjust the return for a taxpayer, colloquially known as “math error authority.” At various times, Congress has expanded this limited authority on a case-by-case basis to cover specific, newly enacted tax code amendments. The IRS would be able to significantly improve tax administration – including reducing improper payments and cutting down on the need for costly audits – if Congress were to enact a proposal contained in the President’s FY 2016 budget request to replace the existing specific grants of this authority with more general authority covering computation errors and incorrect use of IRS tables. Congress could also help in this regard by creating a new category of “correctible errors,” allowing the IRS to fix errors where the IRS has reliable information that a taxpayer has an error on his/her return.
- **Simplification of partnership audits.** Auditing of large partnerships has become very challenging for the IRS, in part because of the way the agency must apply the partnership audit rules contained in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). These rules were designed to improve tax administration by making it possible for the IRS to conduct audits at the partnership level, instead of auditing each individual partner. But TEFRA was enacted when partnerships generally were smaller than they are today, and before they had complicated tiered structures as they do now. The TEFRA rules generally require the IRS to notify each partner at the start of an audit and to push any resulting adjustment down through the partnership to each partner. Thus, a single audit can generate thousands of adjustments. One proposal that has been offered by the Administration would mandate certain streamlined audit and adjustment procedures for any partnership that has 100 or more direct partners, or that has at least one direct partner that is a pass-through entity. Under the streamlined procedures, only direct partners would receive audit adjustments, and any direct partner that was itself a pass-through entity would be responsible for paying the resulting tax.

Chairman Hatch, Ranking Member Wyden and Members of the Committee, this concludes my testimony. I would be happy to take your questions.