GAO Highlights

Highlights of GAO-15-514, a report to Congressional Requesters

July 2015

IRS EXAMINATION SELECTION

Internal Controls for Exempt Organization Selection Should Be Strengthened

Why GAO Did This Study

IRS examines tax-exempt organizations to enforce their compliance with the tax code. Examinations can result in assessment of taxes or revocation of tax-exempt status, among other things.

GAO was asked to review IRS's criteria and processes for selecting exempt organizations for examination. This report (1) describes these processes and (2) assesses the adequacy of examination selection controls.

GAO reviewed IRS criteria, processes, and controls for selecting organizations for examination and spoke with IRS officials; assessed whether IRS controls followed *Standards for Internal Control in the Federal Government*; reviewed random probability samples from two populations of examination files; and conducted tests on populations and random probability samples from three databases used in EO examination selection to determine the adequacy of EO's control implementation (for files closed in fiscal year 2014). GAO also conducted eight focus groups on internal controls topics with EO staff who conduct research or make examination selection decisions.

What GAO Recommends

GAO is recommending that IRS take 10 actions to improve selection control design and implementation, such as ensuring that all selection procedures are included in the IRM and thus subject to executive management approval, and developing additional examination selection monitoring procedures. IRS generally agreed with the recommendations.

View GAO-15-514. For more information, contact James R. McTigue, Jr. at (202) 512-9110 or mctiguej@gao.gov.

What GAO Found

The Exempt Organizations (EO) unit within the Tax Exempt and Government Entities (TE/GE) division at the Internal Revenue Service (IRS) reviews organizations' applications for tax-exempt status to determine whether to grant status and oversees existing exempt organizations' compliance with the tax code. To identify exempt organizations for possible examination, EO uses a variety of information sources: for example, EO receives referrals of exempt organization noncompliance from third parties, such as the public, and other parts of IRS.

EO uses various controls intended to help it select exempt organizations for examination, in an effort to adhere to TE/GE's mission of "applying the tax law with integrity and fairness to all." For example, EO maintains well-documented procedures for several examination selection processes in the Internal Revenue Manual (IRM), IRS's primary, official source of instructions to staff; staff can deviate from procedures that are included in the IRM only with executive management approval. In focus groups, EO staff generally told GAO that these procedures were valuable tools to help them administer the tax law.

However, there are several areas where EO's controls were not well designed or implemented. The control deficiencies GAO found increase the risk that EO could select organizations for examination in an unfair manner—for example, based on an organization's religious, educational, political, or other views. Examples of internal control deficiencies GAO found include the following:

- **Staff could deviate from procedures for some selection processes without executive management approval.** GAO found that procedures for some processes—such as applying selection criteria to organizations under consideration for review—are not included in the IRM, as required by IRS policy. As a result, staff are not required to obtain executive management approval to deviate from these procedures. This increases the risk of unfair selection of organizations' returns for examination.
- **EO management does not consistently monitor selection decisions.** GAO found that IRS does not consistently monitor examinations and database files to ensure that selection decisions are documented and approved, to help ensure fairness. GAO's review of examination files found that approval of some selection decisions was not documented, as required by EO procedures. For example, GAO's analysis of a sample of files suggests that an estimated 12 to 34 percent of cases where staff initially selected an organization for examination, but ultimately decided not to perform the examination, were missing the indication of management approval of the final decision, as required in the IRM. Continuous monitoring is an element of internal control; EO management has not been conducting sufficient monitoring to ensure that required approvals were taking place.