Testimony
Before the Subcommittee on Oversight, Committee on Ways & Means, House of Representatives

IRS EXAMINATION SELECTION

IRS Should Strengthen Internal Controls for Exempt Organization Selection

Statement of Jay McTigue, Director, Strategic Issues
Chairman Roskam, Ranking Member Lewis, and Members of the Subcommittee:

Thank you for the opportunity to discuss our report on Internal Revenue Service (IRS) selection of tax-exempt organizations for examination, which is being released today. The 1.6 million tax-exempt organizations in the United States—ranging from small social services groups to large nonprofit health systems—play a major role in our economy and provide a range of important services.

The Exempt Organizations (EO) unit within the Tax Exempt and Government Entities (TE/GE) division at IRS reviews organizations’ applications for tax-exempt status to determine whether to grant status and oversees existing exempt organizations’ compliance with the tax code. One way through which EO oversees exempt organizations’ compliance is through examinations, which are reviews of an organization’s activities and finances. Examinations can result in assessment of taxes or revocation of tax-exempt status, among other things. EO uses various processes to select exempt organizations for possible examination. For example, EO processes referrals of exempt organization noncompliance from third parties, such as the public, and other parts of IRS. In fiscal year 2014, IRS closed 8,084 examinations of exempt organizations.

My remarks today highlight the key findings of our report on IRS selection of exempt organizations for examination. Specifically, this testimony assesses the adequacy of EO’s controls over the various processes it uses to select exempt organizations.

To conduct this work, we 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 examination files; and tested populations and random probability samples from three databases used in EO examination selection to determine the


adequacy of EO’s internal control implementation (for files closed in fiscal year 2014). We also conducted eight focus groups on internal controls topics with EO staff who conduct research or make examination selection decisions. Our report includes a detailed explanation of the methods used to conduct our work. The work on which this testimony is based was performed in accordance with generally accepted government auditing standards.

In brief, Mr. Chairman, our analysis found that EO has various controls (see figure 1) intended to help ensure that it selects exempt organizations for examination in a way that adheres to TE/GE’s mission of “applying the tax law with integrity and fairness to all.” We found that some of EO’s internal controls are adequate, and align with established selection standards; however, there were several areas where EO’s controls were not well designed or implemented, and we made 10 recommendations for improvement.

Figure 1: Using Internal Controls in Selecting Exempt Organizations for Examination

- **Goal**: Select exempt organizations for examination with integrity and fairness
- **Control Design**: Procedures and other rules IRS sets to carry out the goal efficiently and effectively
- **Control Implementation**: IRS adherence to relevant procedures and other rules on an ongoing basis as it selects exempt organizations for examination

In terms of what is working well, we found that the design and implementation of some EO examination selection controls aligned with
effective internal control standards. For example, EO maintains well-documented procedures for several examination selection processes in the Internal Revenue Manual, IRS’s primary, official source of instructions to staff. Staff cannot deviate from procedures in the Internal Revenue Manual without executive management approval. In focus groups, EO staff generally told us 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 we found increase the risk that EO could select organizations for examination in an unfair manner. Examples of internal control deficiencies we found include the following.

- **Staff could deviate from procedures for some selection processes without executive management approval.** We found that procedures for some processes—such as applying selection criteria to organizations under consideration for review—are not included in the Internal Revenue Manual, as required by IRS policy. As a result, those procedures are not covered by the same control standards as the Internal Revenue Manual. For example, deviations from the Internal Revenue Manual are only allowed with approval by executive management and with appropriate communication to employees, whereas these standards do not explicitly apply to other documents. Reliance on procedures that are outside of the Internal Revenue Manual creates the risk that EO staff could deviate from procedures without executive management approval. This could result in unfair selection of organizations’ returns for examination. Excluding these procedures from the Internal Revenue Manual also reduces transparency, since they would be available to the public if they were in the Internal Revenue Manual.

- **EO management does not consistently monitor selection decisions.** We found that IRS does not consistently monitor examinations and database files to ensure that selection decisions are documented and approved in order to help ensure fairness. In our review of examination selection files, we found that some selection procedures were not consistently followed. For example, referrals that deal with political activity allegations or with what IRS has identified as sensitive allegations or organizations are reviewed by a three-person committee. Four out of fifteen committee referrals we reviewed that were selected for examination were missing a required description of the allegation for the committee. Also, an estimated 12 to 34 percent of cases where EO initially selected an organization for examination,
but the examiner ultimately decided not to perform the examination, were missing documentation of management approval of the final decision, as required in the Internal Revenue Manual. According to internal control standards, controls should be designed to assure that ongoing monitoring occurs in the course of normal operations. Taken as a whole, the deficiencies we found point to insufficient monitoring of case processing.

• **Certain types of referrals are reviewed by only one individual.** Five individuals, known as classifiers, determine the examination potential of referrals. Each classifier is responsible for reviewing specific types of referrals. For example, one classifier reviews high profile referrals (referrals that are sensitive or may attract media attention) and church referrals; another reviews referrals related to political activity. The classifier serves as an initial gatekeeper for determining whether a referral is reviewed by a committee. Aside from general referrals, the classifiers are not cross-trained to review other types of referrals. According to EO officials, classifiers are not cross-trained due to resource shortages. Internal control standards dictate that key duties and responsibilities should be divided among different people to reduce the risk of error. Spreading classification responsibilities for sensitive referrals to more than one classifier could help decrease the potential influence of any one classifier. Even if other safeguards are in place, having the same individual initially classify all political activity or all high profile and church referrals increases the potential for error or unfairness; for example, the classifier could choose not to forward particular kinds of organizations.

In conclusion, EO is faced with the challenging task of overseeing the diverse population of exempt organizations and with enforcing their compliance with the tax laws. EO’s reliance on a variety of processes to select organizations’ returns for examination underscores the importance of having a robust internal control system to ensure selection fairness and integrity. Although EO has some controls in place that are consistent with internal control standards, and has implemented some of these controls successfully, there are several areas where EO’s control system could be strengthened. Many of these deficiencies pose a risk that could lead to selecting (or not selecting) returns for examination based on criteria or practices that fall short of TE/GE’s mission of ensuring fairness and integrity. To help mitigate this risk, we recommended that IRS take 10 actions to improve selection control design and implementation, such as: ensuring that all selection procedures are included in the Internal Revenue Manual and thus subject to executive management approval; developing additional examination selection monitoring procedures; and
implementing a system to ensure that political activity, high profile, and church referrals are not always reviewed by the same classifier. IRS generally agreed with the recommendations.

Chairman Roskam, Ranking Member Lewis, and members of the Subcommittee, this concludes my prepared remarks. I look forward to answering any questions that you may have at this time.

For questions about this statement, please contact me at (202) 512-9110 or mctiguej@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Individuals making key contributions to this testimony were Jeff Arkin, Assistant Director; Deirdre Duffy; Meredith Moles; Amy Radovich; and Lindsay Swenson.
This is a work of the U.S. government and is not subject to copyright protection in the United States. The published product may be reproduced and distributed in its entirety without further permission from GAO. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately.
**GAO’s Mission**
The Government Accountability Office, the audit, evaluation, and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO’s commitment to good government is reflected in its core values of accountability, integrity, and reliability.

**Obtaining Copies of GAO Reports and Testimony**
The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO’s website (http://www.gao.gov). Each weekday afternoon, GAO posts on its website newly released reports, testimony, and correspondence. To have GAO e-mail you a list of newly posted products, go to http://www.gao.gov and select “E-mail Updates.”

**Order by Phone**
The price of each GAO publication reflects GAO’s actual cost of production and distribution and depends on the number of pages in the publication and whether the publication is printed in color or black and white. Pricing and ordering information is posted on GAO’s website, http://www.gao.gov/ordering.htm.

Place orders by calling (202) 512-6000, toll free (866) 801-7077, or TDD (202) 512-2537.

Orders may be paid for using American Express, Discover Card, MasterCard, Visa, check, or money order. Call for additional information.

**Connect with GAO**
Connect with GAO on Facebook, Flickr, Twitter, and YouTube. Subscribe to our RSS Feeds or E-mail Updates. Listen to our Podcasts and read The Watchblog. Visit GAO on the web at www.gao.gov.

**To Report Fraud, Waste, and Abuse in Federal Programs**
Contact:
Website: http://www.gao.gov/fraudnet/fraudnet.htm
E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

**Congressional Relations**
Katherine Siggerud, Managing Director, siggerudk@gao.gov, (202) 512-4400, U.S. Government Accountability Office, 441 G Street NW, Room 7125, Washington, DC 20548

**Public Affairs**
Chuck Young, Managing Director, youngc1@gao.gov, (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, DC 20548

Please Print on Recycled Paper.