



June 2020

# TAX EXEMPT ORGANIZATIONS

## IRS Increasingly Uses Data in Examination Selection, but Could Further Improve Selection Processes

Accessible Version

# GAO Highlights

Highlights of [GAO-20-454](#), a report to the Republican Leader, Committee on Ways and Means, House of Representatives

## Why GAO Did This Study

Exempt organizations often provide charitable services, or in some instances, membership benefits in furtherance of an exempt purpose. They generally do not pay federal income tax. IRS examines exempt organization returns (Form 990 and others) to address noncompliance, which may promote confidence in the tax exempt sector. In 2016, IRS started using three analytical models using Form 990 data to identify potential noncompliance and select returns for examination.

GAO was asked to review IRS's use of Form 990 data. This report assesses (1) IRS's use of data to select returns for examination and, (2) the process IRS has established for selecting returns. GAO analyzed (1) examination data from fiscal years 2016 through 2019 including results from the largest Form 990 model, and (2) model documentation for a generalizable sample. GAO interviewed IRS officials and assessed IRS policies and procedures using relevant standards for internal control.

## What GAO Recommends

GAO makes 13 recommendations, including that IRS establish objectives, revise model documentation, fully document processing and using data in decisions, and regularly evaluate examination selection. IRS agreed with all recommendations except one related to evaluating examination selection methods using consistent historical data over time. GAO continues to believe that this recommendation is valid as discussed in the report.

View [GAO-20-454](#). For more information, contact James R. McTigue, Jr. at (202) 512-9110 or [mctiguej@gao.gov](mailto:mctiguej@gao.gov).

June 2020

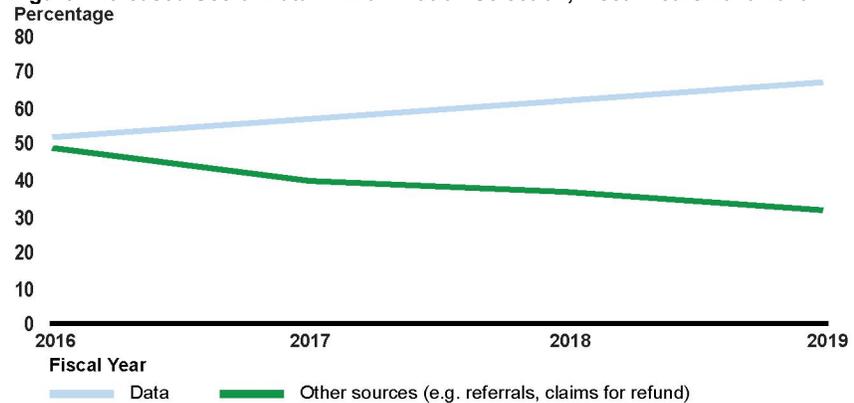
## TAX EXEMPT ORGANIZATIONS

### IRS Increasingly Uses Data in Examination Selection, but Could Further Improve Selection Processes

#### What GAO Found

The Internal Revenue Service (IRS) used data to select almost 70 percent of its examinations of Form 990 returns in fiscal year 2019. Almost half of these examinations were selected using models that score returns for potential noncompliance (see figure).

Figure: Increased Use of Data in Examination Selection, Fiscal Years 2016-2019



Source: GAO analysis of the Returns Inventory and Classification System (RICS). | GAO-20-454

Of the returns examined that were selected using the model, 87 percent resulted in a change to the return, indicating that IRS identified noncompliance. GAO found that the model did not improve change rates compared to prior selection methods and a higher model score is not associated with a higher change rate.

IRS has not fully implemented or documented internal controls in its established processes for analyzing data for examination selection. For example:

- **IRS has not defined measurable objectives for using data to select returns for examination.** Without measurable objectives, IRS cannot assess how well it is doing or fully implement other internal controls.
- **IRS's models have deficiencies affecting the validity and reliability of return scoring and selection.** IRS has incomplete definitions and procedures and did not always follow its definitions when assigning point values for identifying potential noncompliance for examination. As a result, return scoring by the models is not always consistent.
- **IRS did not consistently document the processing and use of data in decision-making on examination selection.** Without such documentation, IRS cannot support its use of data in examination selection in all cases.
- **IRS does not regularly evaluate examination selection.** Examination data were inconsistent across years and IRS only tracks one prior year of data. IRS also did not save data on all returns that the models scored. Without data and regular evaluations, IRS cannot assure that its models are selecting returns as intended and that deficiencies are identified and corrected.

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**Abbreviations**

CP&C	Compliance Planning and Classification
Governance Board	TE/GE Compliance Governance Board
GB	Green Book
Green Book	<i>Standards for Internal Control in the Federal Government</i>
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
MSS	Model Score Sheet
RAAS	Research, Applied Analytics, and Statistics
RCCMS	Reporting Compliance Case Management System
RICS	Returns Inventory and Classification System
SFR	Substitute for return
TE/GE	Tax Exempt and Government Entities
WDS	Weighted disposal score

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June 16, 2020

The Honorable Kevin Brady  
Republican Leader  
Committee on Ways and Means  
House of Representatives

Dear Mr. Brady

To be exempt from federal income tax, an entity must be organized for a purpose specified in the Internal Revenue Code—such as providing charity, enhancing social welfare, or furthering the interests of the organization’s membership—and must operate in accordance with that purpose.<sup>1</sup> Internal Revenue Service (IRS) oversight can help ensure that exempt organizations abide by the purposes that justify their tax exemption. This oversight can also help safeguard the public’s confidence in the integrity of the charitable sector.<sup>2</sup>

The Tax Exempt and Government Entities (TE/GE) division within IRS oversees exempt organizations by conducting examinations and other activities to ensure compliance with the Internal Revenue Code.<sup>3</sup> Examinations are reviews of the books and records of exempt organizations to determine whether they operated in accordance with their exempt purposes, and paid taxes they owed. If TE/GE finds noncompliance, it may impose excise taxes for certain violations, or—in appropriate circumstances—it may revoke an organization’s tax-exempt status. Limited resources have prompted TE/GE to try refining its

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<sup>1</sup>Section 501 of the Internal Revenue Code covers the majority of these organizations, which includes private foundations and public charities, as well as social welfare organizations, and business leagues. Other types of entities are also wholly or partially tax exempt, such as farmers’ cooperatives, political organizations, as are education-oriented programs. 26 U.S.C. §§ 501(c)(3); 521; 527; 529-530.

<sup>2</sup>GAO, *Tax-Law Enforcement: IRS Could Better Leverage Existing Data to Identify Abusive Schemes Involving Tax-Exempt Entities*, [GAO-19-491](#) (Washington D.C.: Sept. 5, 2019).

<sup>3</sup>Other activities include letters requesting delinquent or corrected returns, or educating taxpayers on requirements.

examination selection methods to focus examinations on the organizations with the highest potential for noncompliance.

In a 2015 review, we found deficiencies in TE/GE's methods for selecting tax-exempt organizations for examination.<sup>4</sup> However, we noted that in fiscal year 2012, TE/GE had started analyzing more data reported on the Form 990, Return of Organization Exempt from Income Tax, to identify potential noncompliance and to select returns for examination. We did not make recommendations on the use of data for examination selection.

You asked that we review TE/GE's use of Form 990 data for exempt organization compliance efforts. This report assesses (1) the use of data to select tax exempt organization returns for examination; and (2) the process TE/GE has established to select returns for examination.

To assess TE/GE's use of data to select exempt organization returns for examination, we analyzed TE/GE data for examinations closed from fiscal years 2016 to 2019. The analyses included information on examination closures and changes made to returns because of examinations. Based on our testing of the data and review of documentation and interviews, we determined that the examination data were reliable for the purposes of assessing TE/GE's selection processes. We reviewed the examination selection process and outcomes from TE/GE's Form 990 examination selection model.<sup>5</sup>

To assess the process that TE/GE established to select returns for examination, we analyzed TE/GE documentation relative to five key internal controls steps and four other controls that we selected from the *Standards for Internal Control in the Federal Government* (Green Book or GB).<sup>6</sup> Internal control comprises the plans, methods, policies, and procedures used to fulfill an agency's objectives. We reviewed the

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<sup>4</sup>GAO, *IRS Examination Selection: Internal Controls for Exempt Organization Selection Should Be Strengthened*, [GAO-15-514](#) (Washington D.C.: July 13, 2015).

<sup>5</sup>The Form 990 model uses a set of data queries that identify potential noncompliance using responses on the Form 990. For purposes of this report, a query reviews databases to identify responses on returns that may indicate noncompliance. Returns receive a score based on the number and types of queries hit.

<sup>6</sup>GAO, *Standards for Internal Control in the Federal Government*, [GAO-14-704G](#) (Washington, D.C.: Sept. 10, 2014). The Green Book refers to "principles" and "attributes" as internal controls, and applies to any federal agency; we adjusted the language where necessary to focus on TE/GE's use of data in examination selection.

Internal Revenue Manual (IRM), work plans, desk guides, procedures, examination selection processes, model documentation and other documents.<sup>7</sup> In addition, we analyzed a generalizable stratified random sample of data queries from three examination selection models to verify whether TE/GE tests and follows its approval and documentation procedures for new data queries.<sup>8</sup> We interviewed officials in TE/GE's Compliance Planning and Classification (CP&C) office and IRS's Research, Applied Analytics and Statistics (RAAS) division. For details on our scope and methodology, see appendix I.

We conducted this performance audit from November 2018 to June 2020 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Background

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### Filing Requirements for Exempt Organizations

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IRS Form 990-series return or notice must be filed by most organizations exempt from income tax under Internal Revenue Code section 501(a), and certain political organizations and nonexempt charitable trusts.<sup>9</sup> TE/GE uses Form 990 reporting for promoting compliance and enforcing federal tax law for tax-exempt organizations (see appendix II for a copy of

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<sup>7</sup>The IRM is IRS's official source of guidance.

<sup>8</sup>We selected a stratified random sample of 114 queries from the 354 unique queries for the Form 990, Form 990-EZ, *Short Form Return of Organization Exempt from Income Tax*; and Form 990-PF, *Return of Private Foundation*, models.

<sup>9</sup>A nonexempt charitable trust is a trust which is not tax exempt but all of the unexpired interests are devoted to one or more charitable purposes, and a charitable contribution deduction was allowed. 26 U.S.C. § 4947(a)(1). It is treated as a private foundation unless it meets the requirements for an exclusion that classifies it as a public charity.

the Form 990 and a list of its schedules).<sup>10</sup> Form 990 asks for information about an organization such as:

- employees, governance, and compensation;
- revenue and expenses;
- assets and liabilities;
- employment tax compliance; and
- specific organizational issues, such as lobbying by charities and private foundations.

TE/GE redesigned the Form 990 for the first time in nearly 30 years for tax year 2008, and has made subsequent changes to the form (see appendix III for a summary of the changes). For tax year 2017, which is the most recent year of completed filing data, organizations filed 319,183 Form 990s. Beyond the basic Form 990, other versions include:

- Form 990–EZ, *Short Form Return of Organization Exempt from Income Tax*. This form reduces the filing burden on small tax-exempt organizations. Organizations with less than \$200,000 in gross receipts and less than \$500,000 in total assets may use it. For tax year 2017, 232,764 Form 990-EZ's were filed.
- Form 990–N, *Electronic Notice (e-Postcard) for Tax-Exempt Organizations Not Required to File Forms 990 or 990–EZ*. Most small organizations whose annual gross receipts are normally \$50,000 or less may file Form 990-N. For tax year 2017, 652,280 Form 990-N's were filed.
- Form 990–PF, *Return of Private Foundation*. In addition to private foundations, nonexempt charitable trusts treated as private foundations are required to file Form 990-PF. For tax year 2017, 113,658 Form 990-PF's were filed.

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<sup>10</sup>The 2019 form is 12 pages long, has 12 parts, and has 16 schedules that an organization may have to file. Not every organization will have to file all schedules (e.g. only hospitals are required to file Schedule H).

Certain larger organizations are required to electronically file their returns.<sup>11</sup> The Taxpayer First Act of 2019 requires all organizations to electronically file Form 990's for tax years beginning after July 1, 2021.<sup>12</sup> TE/GE can assess financial penalties for failing to file a required Form 990.<sup>13</sup> As an employer, or if an exempt organization generates unrelated business income, additional tax reporting requirements may apply, such as for employment tax or unrelated business income.<sup>14</sup>

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### Several TE/GE Entities Are Involved in Examination Selection Decisions

A 2017 TE/GE reorganization created CP&C to provide a centralized approach to compliance planning, examination selection and assignment and planning and monitoring activities. CP&C has three groups as follows:

1. **Issue Identification and Special Review** identifies and develops issues for examinations or compliance activities and certain criteria for examination selection.
2. **Classification and Case Assignment** uses IRS staff known as “classifiers” to review returns for examination under different examination sources (see appendix IV). Classification is the process of determining whether a return should be selected for compliance

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<sup>11</sup>Exempt organizations with \$10 million or more in assets may be required to electronically file their returns if the organization files at least 250 returns in a calendar year, including information returns. Private foundations and nonexempt charitable trusts are required to file Forms 990-PF electronically if they file at least 250 returns annually. 26 C.F.R. § 301.6033-4. All Form 990-N's are electronic.

<sup>12</sup>Pub. L. No. 116-25, § 3101, 133 Stat. 981, 1015–1016 (2019), *codified at* 26 U.S.C. §§ 6011(h), 6033(n). Although this electronic filing applies in tax years beginning after July 1, 2019, the U.S. Department of the Treasury exercised its authority under the statute to delay this requirement for Form 990-EZ filers. For tax years ending before July 31, 2021, IRS will accept paper or electronic forms. Organizations can differ in start dates for their tax years.

<sup>13</sup>26 U.S.C. § 6652(c). TE/GE officials said they do not track penalty amounts.

<sup>14</sup>Employment tax returns include: Forms 940, *Employer's Annual Federal Unemployment Tax Return* and Form 941, *Employer's Quarterly Federal Tax Return*, and Form W-2, *Wage and Tax Statement*. Form 990-T, *Exempt Organization Business Income Tax Return*, is an income tax return. Generally, unrelated business income comes from a trade or business regularly conducted by an exempt organization and not substantially related to its exempt purpose or function.

activities, what issues should be the primary focus of the compliance activity, and the type of compliance activity that should be conducted.

3. **Planning and Monitoring** develops an annual work plan and monitors performance. The work plan details the number of examination starts, closures and other measures. It develops classification requests to ensure that enough returns are available to meet work plan goals.

TE/GE's Compliance Governance Board (Governance Board) oversees TE/GE's compliance program, including CP&C operations such as approving priority issue areas—known as compliance strategies. The Governance Board also reviews program goals, considers metrics and reporting, and reviews the performance of compliance strategies. The Governance Board has five TE/GE executives plus counsel who are voting members as well as three non-voting members.

The Exempt Organizations examinations group is responsible for compliance activities. Examinations have various outcomes for an organization. The most severe outcome is revocation of tax exempt status.<sup>15</sup> Taxes—such as employment or excise—may be assessed as a result of an examination. In fiscal year 2019, approximately \$131 million in taxes were assessed.

TE/GE conducts compliance contacts—non-examination correspondence such as compliance checks and soft letters—that are used to handle some compliance issues. For example, compliance checks determine whether specific reporting or filing requirements have been met. A “soft letter” notifies an organization of changes in tax-exempt law or potential compliance issues. A response to these letters is not required. TE/GE also reviews tax-exempt hospitals for compliance with certain community benefit requirements.<sup>16</sup> In fiscal year 2019, TE/GE closed 1,470 compliance checks, sent 3,955 soft letters, and closed 750 hospital reviews. Compliance checks and hospital reviews can result in an examination while responses to soft letters may result in a compliance check.

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<sup>15</sup>In addition, exempt status is revoked if an organization did not file the required Form 990 for 3 consecutive years. 26 U.S.C. § 6033(j).

<sup>16</sup>These requirements include meeting the Community Health Needs Assessment requirements, among others. 26 U.S.C. § 501(r). The community benefit standard, as outlined in Rev. Rul. 69-545, is a test IRS uses to determine whether a hospital is organized and operated for the charitable purpose of promoting health.

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## Exempt Organizations Identified for Examination Originate from Many Sources

TE/GE identifies exempt organization returns for examination from many sources and categorizes examinations into three groups, known as portfolios: (1) Data Driven Approaches, (2) Referrals and Other Casework, and (3) Compliance Strategies. All three rely on data, to some extent, to make decisions on selecting returns for examination.

### Data Driven Approaches Portfolio

This portfolio uses analytical models and queries based on quantitative criteria to identify potential examinations.<sup>17</sup> TE/GE has three separate models that review exempt organization data from Forms 990, 990-EZ, and 990-PF for compliance.<sup>18</sup> The models “score” returns for examination based on potential noncompliance. The Form 990, 990-EZ and 990-PF models have 354 unique queries.<sup>19</sup> For purposes of this report, a query reviews databases to identify responses on returns that may indicate noncompliance because they do not meet certain criteria or expected values, such as exceeding a dollar threshold. Exempt Organizations Examination staff developed many of the queries, based on information collected on the Form 990 after it was redesigned for tax year 2008, according to TE/GE officials. As queries were developed, staff tested and used them to identify certain potentially noncompliant populations and to identify returns that were flagged by multiple queries.

Starting in fiscal year 2016, TE/GE began using queries in models. The models use a scoring system that applies weights, or points, to each query result to generate a score—which for the Form 990 model has ranged from zero to more than 50—for a return. The models also screen out returns that are approaching a statute of limitations date, if the

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<sup>17</sup>TE/GE’s fiscal year 2020 Program Letter started referring to the models as “query sets.” A TE/GE official said this change more accurately reflects that it is not conducting predictive modeling. We are using the term “models” because TE/GE’s documentation up to fiscal year 2020 uses that term.

<sup>18</sup>TE/GE also has developed a model for Form 5227, *Split Interest Trust Information Return* from which IRS plans to start examinations during fiscal year 2020.

<sup>19</sup>Some queries appear in more than one model.

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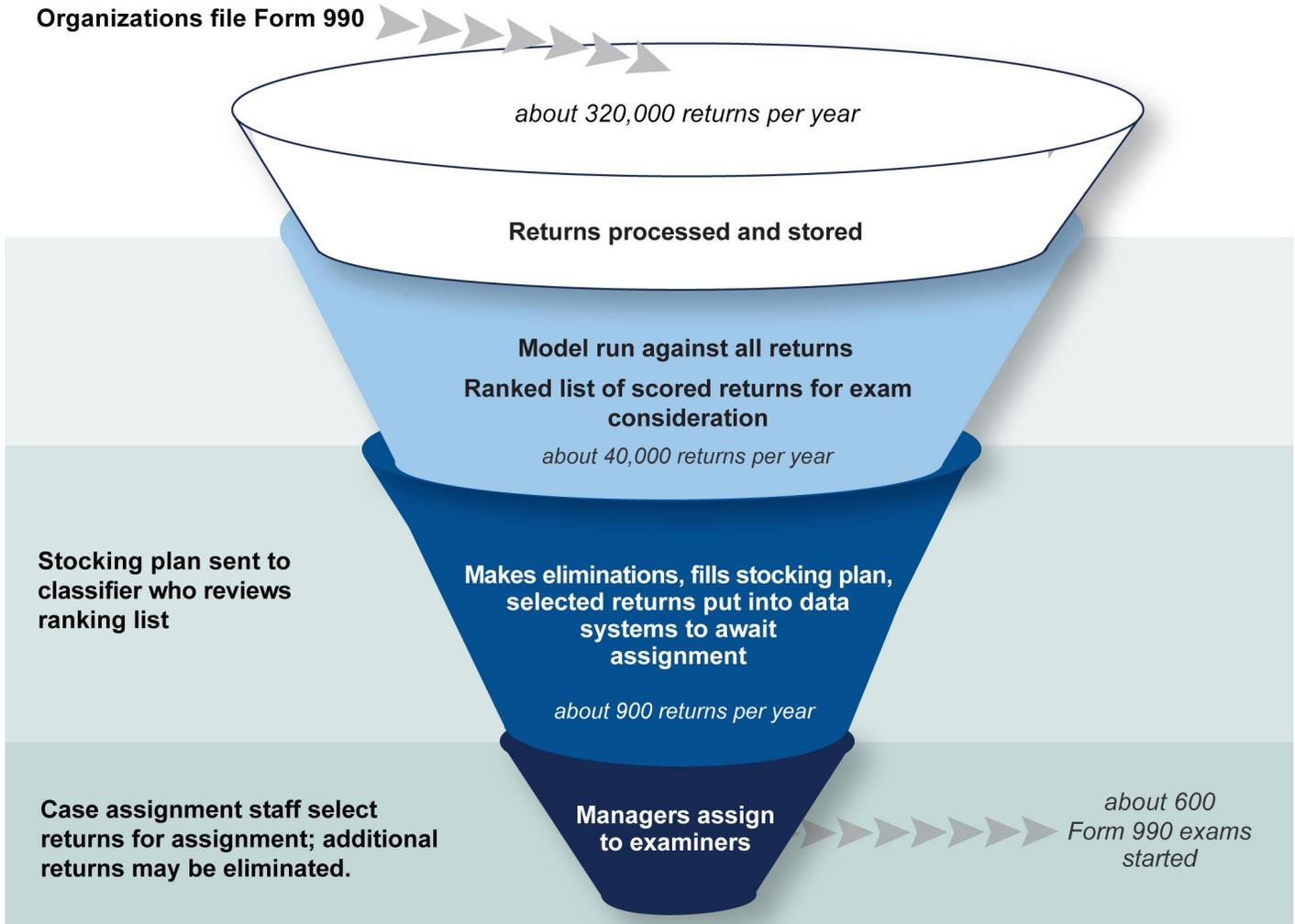
organization is not active, or has a current or recent examination history.<sup>20</sup> Since November 2017, staff have been able to submit potential compliance issues for consideration through an online submission portal for Governance Board approval. CP&C has the option of considering whether these ideas result in model changes, according to IRS officials.

Twice a year, each model is run using the latest data, and generates a Model Score Sheet (MSS). The MSS is a ranked list of returns that score above a minimum threshold. A classifier uses the ranking to identify returns for potential examination. Although the models screen for examination status and statute of limitations, a TE/GE official said the classifier also checks whether the statute of limitations date is near and whether the organization recently had undergone an examination or compliance check, as well as whether the return was identified under another selection method. This official explained that a classifier checks the criteria because conditions may have changed since the model's last run. The classifier selects returns to fulfill a stocking plan, which identifies the number and type of returns to be examined to meet work plan requirements. See figure 1.

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<sup>20</sup>Statute of limitation dates are based on the filing due date of the return. In general, IRS has 3 years from the due date or filing date, whichever is later, to close an examination. 26 U.S.C. § 6501(a).

Figure 1: Use of Form 990 Model Data in Examination Selection



Source: GAO analysis of Internal Revenue Service (IRS) information. | GAO-20-454

Aside from the three models, TE/GE also uses other methods and data to identify and develop compliance work. The Data Driven Approaches portfolio includes approaches that TE/GE developed in partnership with IRS's RAAS division. The partnership began in 2016 and continues today, according to IRS officials. The portfolio also includes some of the queries that TE/GE ran prior to fiscal year 2016 for examination selection. Some of these examinations remained open as of fiscal year 2019.

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### Referrals and Other Casework Portfolio

Although not all of the returns selected for examination in this portfolio rely on data for examination selection, we describe them all below.

- **Referrals.** Referrals are complaints about exempt organization noncompliance made by third parties, including the public and other IRS offices or divisions.
- **Post Determination Compliance.** Sampling and queries are used to identify organizations that file Form 1023-EZ.<sup>21</sup>
- **Claims.** Claims are requests for tax refunds, adjustments of tax paid, or credits not previously reported or allowed.
- **Form 990 Queries (pre-model):** These queries were run prior to fiscal year 2016. Some of these examinations remained open as of fiscal year 2019.
- **Training.** TE/GE uses these examinations, selected based on various methods, to teach examiners.
- **Other Projects.** TE/GE initiated these examinations under older compliance projects, using a variety of selection methods.

### Compliance Strategies Portfolio

The Compliance Strategies portfolio consists of compliance issues that originated from a Compliance Issue Submission Portal for TE/GE staff. The strategies are approved by the Governance Board, which results in adding the compliance strategy to the work plan. In fiscal year 2019, TE/GE closed examinations under three compliance strategies, including private foundation loans, and for-profit entities that converted to 501(c)(3) organizations. Returns are selected using sampling or other uses of data.

Table 1 shows examinations closed for the three portfolios.

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<sup>21</sup>In 2014, IRS introduced Form 1023-EZ, *Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, which created efficiencies in processing. Given concerns about whether the application adequately screens organizations, TE/GE is studying the compliance of these filers.

**Table 1: Number of Exempt Organization Examinations Closed, by Source, Fiscal Years 2018 and 2019**

<b>Examination Sources, by Portfolio</b>	<b>2018</b>	<b>2019</b>
<b>Data Driven Approaches (total)</b>	<b>2,094</b>	<b>1,979</b>
Form 990 model	1,430	1,497
Form 990-EZ model	175	194
Form 990-PF model	175	153
Research, Applied Analytics and Statistics division projects	214	78
Form 990 queries (pre-model)	72	28
Other	28	29
<b>Referrals and Other Casework (total)</b>	<b>2,811</b>	<b>1,726</b>
Referrals	960	562
Post-determination compliance	669	565
Claims	456	353
Form 990 queries (pre-model)	334	16
Other	392	230
<b>Compliance Strategies</b>	<b>4</b>	<b>21</b>
<b>Total</b>	<b>4,909</b>	<b>3,726</b>

Source: GAO analysis of Returns Inventory and Classification System (RICS) data. | GAO-20-454

Note: A partial government shutdown affected IRS in fiscal year 2019 for 21 working days. Being a new work source, only five compliance strategies resulted in closed examinations for fiscal years 2018 and 2019.

Once an examination is underway, an examiner may expand it to include an organization’s returns for other tax years or other types of returns such as employment tax returns. IRS refers to these additional examinations as “pick-ups,” each of which is counted as a separate examination. Examiners must obtain manager approval to expand an examination.

Examiners are required to check that an organization filed all returns that are required. If the examiner finds that a return was not filed—such as an employment tax return—and is unable to secure the return, he or she may prepare a “dummy” return called a substitute for return (SFR).<sup>22</sup> The organization’s activities, records, and documents may then be examined.

In 2017, TE/GE hired a contractor to assess aspects of the exempt organization process for examination selection, with a focus on the Form 990 model. In January 2018, the contractor released a report on the

<sup>22</sup>An examination can lead to a pick-up and a substitute for return with each counted as separate examinations.

development and operation of the models. The contractor released a second report in July 2018 on the Form 990 model performance. The contractor found the model was not always identifying the “next best case” as TE/GE intended because scores did not consistently predict certain measures of noncompliance.

Across both reports, the contractor made 17 recommendations, which we discuss later in this report (see appendix V). As of March 2020, TE/GE implemented one recommendation on model update submissions and part of another on hiring assessments. In September 2019, TE/GE initiated another study with the same contractor—with a planned release of the report in September 2020—on developing alternatives to the Form 990 model.

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## Over Half of Exempt Organizations Selected for Examinations Are Identified Using Data, with No Assurance That the Models Produce Better Outcomes

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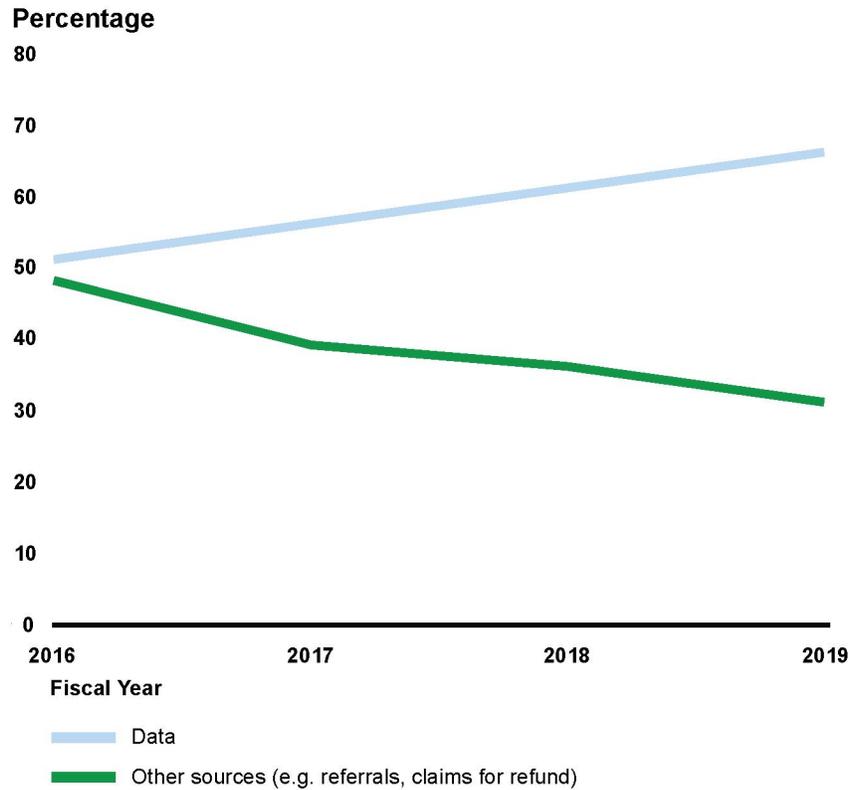
### Reliance on Data for Examination Selection Has Increased in Recent Years

Since the Form 990 model was first run for fiscal year 2016, the percentage of examinations closed that were identified by using data, such as through models or queries, has increased each year, as shown in figure 2.<sup>23</sup> Almost half of these examinations are from the models.

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<sup>23</sup>Data are used as part of selection across all three portfolios. We did not analyze data prior to fiscal year 2016 because of the difficulty of researching the selection criteria for each of a large number of projects.

**Figure 2: Increased Reliance on Data in Exempt Organization Examination Selection, Fiscal Years 2016-2019**



Source: GAO analysis of the Returns Inventory and Classification System (RICS). | GAO-20-454

Note: The “data” and “other sources” represent 97 percent of all examination closures. The remaining examinations were either reported under project codes that include work from more than one source, or the selection criteria for the project were not readily available to determine the use of data.

This increased reliance on using data in selecting returns for examination offers potential efficiencies. For example, a potential efficiency from using data to find possible noncompliance could mean fewer steps for staff who classify returns. Ultimately, this could allow TE/GE to shift staff from classifying returns to doing compliance activities such as examinations to confirm any actual noncompliance.

Another potential efficiency would be selecting more examinations that find changes to the return. To measure the outcomes of examinations, TE/GE computes a “change rate,” or the percentage of closed examinations with a change to the return. In general, a higher change rate indicates that more examinations found noncompliance. Examinations selected using data have a slightly better change rate than

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other selection sources (84 percent versus 82 percent) for closures in fiscal years 2016 through 2019.

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## The Form 990 Model's Contribution to Improving Change Rates Is Not Clear

Similar to all examinations that used data, the change rate for examinations selected using data through the Form 990 model (87 percent) was higher than the change rate for other selection sources (82 percent) in fiscal years 2016 through 2019. However, we found evidence that the changes identified in examinations did not clearly result from using the Form 990 model's scoring system.<sup>24</sup> Specifically:

- The model has not improved change rates compared to pre-model Form 990 queries.
- A higher model score is not associated with a higher change rate.
- Most examination changes credited to the model come from pick-up returns and SFR's that examiners identify rather than from primary returns identified by the model score.

### Form 990 Model Scoring Has Not Resulted in Higher Change Rates, Compared with Pre-Model Queries

The scoring generated by the Form 990 model has not improved change rates compared with the Form 990 queries that TE/GE used prior to the model. The change rates for both the Form 990 model and the pre-model queries, for fiscal years 2016 through 2019, was 87 percent.<sup>25</sup>

Similarly, for the last 2 fiscal years, the change rate for all Form 990 models was roughly equivalent to the change rate for other selection sources of exempt organization examinations. As shown in table 2, the models had a slightly higher change rate in fiscal year 2018, and a slightly lower change rate in 2019, compared to the other sources.

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<sup>24</sup>We focused on the Form 990 model because it produced most examinations. In fiscal year 2019, the Form 990 model had 1,497 closed examinations while the Forms 990-EZ and 990-PF models resulted in 194 and 153 closed examinations, respectively.

<sup>25</sup>Before implementing the Form 990 models in fiscal year 2016, TE/GE used around 150 queries to identify returns for examination. Since 2016, TE/GE has been phasing out use of these queries but continued with examinations that were open. Many of these queries formed the basis for the models.

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**Table 2: Change Rates from Model Examinations Are Similar to Rates from Other Examination Sources, Fiscal Years 2018 and 2019**

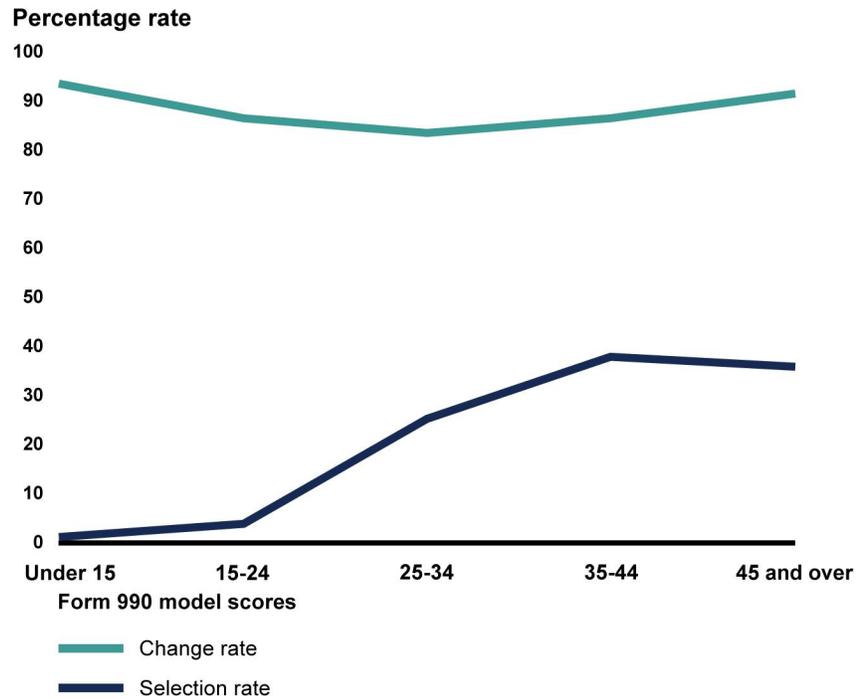
Examination source	2018	2019
Form 990 model	87	87
Form 990-EZ model	89	89
Form 990-PF model	75	59
Form 990, 990-EZ and 990-PF models combined	86	85
All other exempt organizations examination sources	83	88

Source: GAO analysis of Returns, Inventory and Classification Systems (RICS) data. | GAO-20-454

Higher Model Score Is Not Associated with Higher Change Rate from Examination

Form 990 model scores for returns do not consistently predict examination change rates based on our analysis of examination closures since the model's first run in 2016 through fiscal year 2019; the scores better predicted the rate at which returns were selected for examination. See figure 3.

**Figure 3: Selection Rate but Not Change Rate Is Related to Model Score, Fiscal Years 2016-2019**



Source: GAO analysis of the Returns Inventory and Classification System (RICS). | GAO-20-454

Note: This figure only includes data from the Form 990 model project code.

The figure shows little relationship between model scores and change rates; change rates remained relatively flat as model scores increase.<sup>26</sup> While change rates were slightly higher for the less than 1 percent of returns scoring 45 or above relative to lower-scoring returns, TE/GE only examined 65 returns during fiscal years 2016 through 2019 that scored this high. The overall correlation between model scores and change rates is  $-.02$ .<sup>27</sup>

<sup>26</sup>Of the returns examined under the Form 990 model project code for fiscal years 2016-2019, we found score matches for 45 percent of them. Although this is less than half, the general relationship we found between change rate and model score is similar to what TE/GE's contractor found in 2018.

<sup>27</sup>This measures the degree two variables change together in a linear manner; simultaneous increasing or decreasing is called positive correlation, while one increasing and the other decreasing is called negative correlation.

A TE/GE official said that it is not difficult to find a small issue on a return, which allows for a change regardless of score. To attempt to measure the severity of an examination change, TE/GE developed a weighted disposal score (WDS).<sup>28</sup> However, TE/GE does not have documented criteria or justifications for how the weights were developed. A TE/GE official acknowledged that TE/GE has not used WDS because of questions about how consistently the weights have been developed. If WDS was to be used as a measure, TE/GE would need to ensure the adequacy of the support for the related weights and scores.

According to TE/GE's fiscal year 2020 Program Letter, the model relies on quantitative criteria, "which allows TE/GE to allocate resources that focus on issues that have the greatest impact." To the extent that a higher model score does not predict a higher change rate, the model is not selecting returns with the greatest impact. Further, taxes assessed per return also indicate that examinations are not having the greatest impact. For fiscal years 2016 through 2019, the examinations credited to the model averaged \$2,460 in proposed tax assessments per return, compared with an average of \$19,042 for the rest of the exempt organization examinations.

TE/GE acknowledged that its scoring methods are limited because it does not utilize modern data practices. It contracted for a study, to be completed in September 2020, of alternative model architectures and scoring methods that incorporate best practices for using criteria and options for scoring returns.

#### Most of the Changes Credited to the Form 990 Model Are Driven by Examinations of Returns Not Identified by the Model Score

As shown in table 3, the Form 990 model scoring did not account for most closed examinations and examination changes credited to the model during fiscal years 2016 through 2019. Rather, examinations of "pick-up" returns and substitutes for returns (SFRs) accounted for most closed examinations and produced a higher change rate than examinations of

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<sup>28</sup>When closing an examination, the examiner records a code indicating the type of change to the return, if any. The WDS ranges from one (no change) to 10 (revocation of tax-exempt status).

primary returns scored by the model.<sup>29</sup> Examiners find these other returns during examinations of returns identified by the model.

**Table 3: Pick-up Returns and Substitutes for Returns (SFR) Accounted for Most Closed Examinations and Have Higher Change Rates Than Returns Identified by the Model, Fiscal Years 2016–2019**

	Percent of closed examinations	Change rate
<b>Primary returns scored by model</b>	<b>44</b>	<b>78</b>
<b>Pick-up returns and SFRs-</b>	<b>56</b>	<b>94</b>
Prior year Form 990's	2	95
Employment tax returns	36	93
Form 990-T	8	89
Other returns	10	99
<b>Form 990 model overall</b>	<b>100</b>	<b>87</b>

Source: GAO analysis of Returns, Inventory and Classification Systems (RICS) data. | GAO-20-454

The higher change rates for pick-up and SFR returns compared to the primary returns identified by the model support TE/GE’s policy to examine all pick-up returns and SFRs that meet examination criteria. However, this raises questions about how well the model identifies noncompliant returns. Given the lower change rate for the returns the model scored, the queries for noncompliance on the Form 990 may not be effective. While the model includes queries on noncompliance related to “pick-up” issues such as unfiled employment tax returns, the necessary data were not available to allow us to analyze how often these queries identified the primary return for potential noncompliance. As discussed later, an analysis of queries could provide insight into the validity of the model.

## TE/GE Has Not Fully Implemented and Documented Internal Controls for Assessing and Using Data for Examination Selection

Internal control should be an integral part of an agency’s operational processes and structure to help managers achieve their objectives on an ongoing basis. When evaluating implementation, management

<sup>29</sup> For fiscal year 2019 alone, our analysis showed that 61 percent of examinations credited to the Form 990 model focused on pick-up returns or SFRs rather than the primary returns identified by the model. By contrast, for all other closed exempt organization examinations, about 30 percent were pick-up returns or SFRs.

determines if the control exists and is operational. A deficiency in implementation exists when no such control is present or is not implemented correctly, preventing objectives from being met.

Documentation is required to show the effective design, implementation, and operation of an internal control system. The level and nature of documentation can vary based on the size of the agency and the complexity of its processes. Management exercises judgment in determining the extent of documentation that is needed.

TE/GE has not fully implemented or documented internal controls for analyzing data for examination selection, meaning it cannot be assured that its selection decisions will produce the desired outcomes. The internal controls range from two controls that TE/GE adequately documented and implemented to seven others where TE/GE did not. The seven include five controls presented as sequential steps in using data for making selection decisions as well as two controls addressing timely documentation of Internal Revenue Manual (IRM) sections and risk management.

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### TE/GE Has Implemented Two Controls for Building a Positive System in Selecting Returns for Examination

The first internal control TE/GE implemented involved assessing staff competence. To ensure competence in using data to make decisions, TE/GE officials contracted with data specialists for modeling expertise to incorporate statistical and machine learning into examination selection.<sup>30</sup> Bringing in this modeling expertise was an important step because exempt organization examinations staff, rather than statisticians or data analysts, initially developed the examination selection models, according to TE/GE officials. TE/GE also provided documents on training and basic duties for staff when analyzing data.

#### What are Internal Controls and Why Do They Matter?

One way federal agencies can improve accountability in achieving their missions is to implement an effective internal control system. Effective internal control comprises the plans, methods, policies, and procedures

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<sup>30</sup>Machine learning is a set of technologies that includes automated systems able to perform tasks that normally require human intelligence and decision-making.

used to fulfill objectives on an ongoing basis. It serves as the first line of defense in safeguarding assets and increases the likelihood that an agency will achieve its objectives while adapting to changing environments, demands, risks, and priorities. Effective internal control provides reasonable, not absolute, assurance that an organization will meet its objectives.

Source: GAO. | GAO-20-454

The second internal control involved communicating inside and outside of TE/GE. Internally, TE/GE staff could provide feedback through an online compliance issue submission portal in fiscal year 2018. Submissions may become compliance strategies or model queries. As for external communication, TE/GE collaborated on data-related issues in an IRS-wide group and with statistical specialists in the RAAS division. For example, RAAS identified potential data sources for compliance issues and drew samples for certain compliance strategies to test rates of noncompliance. In addition, to show how it communicates essential information with staff and outside parties, TE/GE provided examples on disseminating guidance and examination accomplishments, including examination starts and closures.

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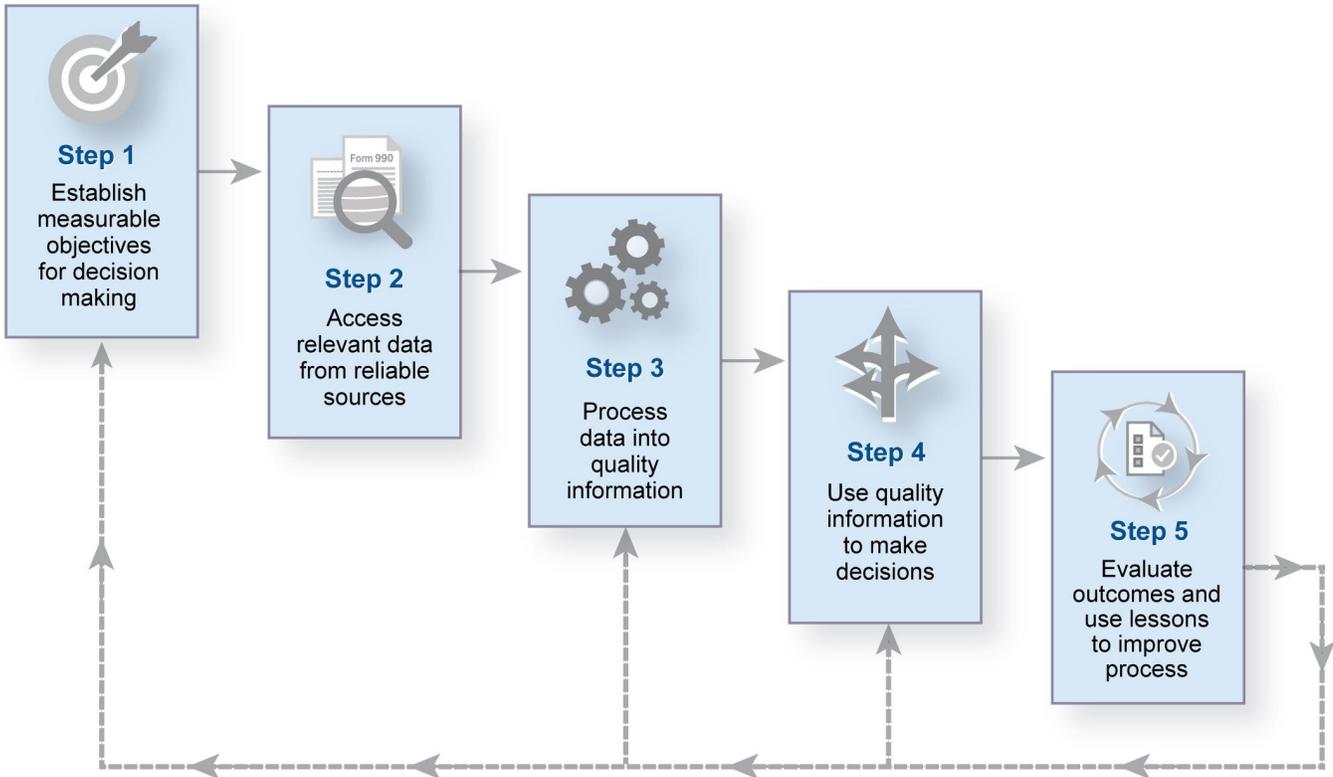
### TE/GE Did Not Fully Implement and Document Controls over Processes and Data Used to Select Returns for Examination

TE/GE did not fully implement and document internal control over the processes and data used to select returns for examination. These processes cover five key steps for using data to decide which returns to select for examination (see figure 4).<sup>31</sup>

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<sup>31</sup>We developed these five key steps based on standards established in the Green Book (see appendix I).

**Figure 4: Five Key Steps in Analyzing Data to Make Examination Selection Decisions**



Source: GAO analysis. | GAO-20-454

Effective internal controls would enable TE/GE to show how feedback and lessons learned in Step 5 can help it better determine how to create and use quality information (Step 3) and what decisions to make (Step 4) when pursuing the established objectives (Step 1). However, TE/GE has not defined measurable objectives or undertaken regular evaluations to assess progress toward objectives. Although TE/GE was able to describe its approach for accessing relevant and reliable data, processing those data into quality information and using the data to make decisions, it was not able to fully document how its control processes worked, as discussed below.

TE/GE Has Not Defined Measurable Objectives for Selecting Returns for Examination

Since its 2017 reorganization, TE/GE has not established measurable objectives to select exempt organization returns for examination (see figure 5).

Figure 5: Step 1



**Establish measurable objectives for decision-making**

Management **defines objectives** in measurable terms so performance in achieving them can be assessed. (Green Book 6.04)

Source: GAO. | GAO-20-454

Specifically, TE/GE has not produced formal objectives that are aligned with its mission and the IRS strategic plan, are expressed in quantitative terms, and are related to examination selection and program outcomes. TE/GE documents, including Program Letters and Business Performance Reviews, refer to outcomes that could constitute objectives—such as improving the models and advancing data analytics to drive decisions about identifying and addressing existing and emerging areas of noncompliance—but they do not identify them as such.<sup>32</sup>

TE/GE officials acknowledged the need to establish measurable objectives. They said their efforts are evolving and they need to improve analytical abilities to help assess the capacity for meeting objectives. For example, one official said they are working to establish objectives at the onset of a compliance strategy. Without measurable and defined objectives, TE/GE cannot effectively analyze how well it selects returns for examination and lacks a clear vision of what it is trying to achieve. A lack of measurable objectives also hinders implementing other internal controls, such as evaluating performance or assessing risk, as discussed later.

<sup>32</sup>The annual TE/GE Program Letter describes compliance priorities and plans. The Business Performance Review covers the status of issues such as performance, key initiatives, budget, and staffing.

TE/GE Could Not Demonstrate that It Has Controls in Place to Catch Certain Form 990 Errors but Electronic Filing Will Likely Increase Data Reliability

The IRM has procedures for processing Form 990 data, which include controls over acceptance and transmission of the data (see figure 6).

Figure 6: Step 2



**Access relevant data from reliable sources**

Management **obtains relevant data from reliable internal and external sources in a timely manner** based on data requirements. (Green Book 13.04)

Source: GAO. | GAO-20-454

TE/GE provided data that showed error rates for electronically filed returns filed in 2019 were between 1 and 4 percent. However, taxpayer or transcription error rates for paper returns filed in 2019 were between 19 and 32 percent of filed returns, depending on the version of the Form 990. TE/GE was not able to show that it regularly reviews and remediates such errors to ensure the reliability of Forms 990 data. However, under the Taxpayer First Act of 2019, electronic filing of all Forms 990 will be required for tax years starting July 2, 2021. This change should remediate the known errors from paper-filed returns and increase data reliability.

Processing Queries for the Model Did Not Always Produce Quality Information

We found several issues with TE/GE's processing of queries in the Form 990, 990-EZ and 990-PF models that affect the validity or reliability of the scores that the models generate to rank returns for examination selection (see figure 7).

Figure 7: Step 3



**Processes data into quality information**

Management **processes the obtained data into quality information** that supports the internal control system (i.e., using data in decision-making). (Green Book 13.05)

Management should use **quality information** to achieve the entity’s objectives. (Green Book 13.01)

Management **documents policies** on the responsibilities for data collection, input, and analysis. (Green Book 12.02)

Source: GAO. | GAO-20-454

As a result, TE/GE cannot ensure that the model scores properly rank the returns for examination selection. Specifically, TE/GE does not consistently assign point values for the queries used to generate the model scores and inform selection decisions. We also found errors in TE/GE’s documentation of the queries, which lead to redundant queries, and inflated model scores. Finally, TE/GE has no control procedures to ensure consistent testing of proposed queries.

**Inconsistent Point Values for Queries Raise Concerns about Model Scores**

We estimate that for 24 percent of queries (83 queries) from the models, TE/GE staff did not assign point values for queries consistent with its definitions for the four categories (see table 4).<sup>33</sup> Not implementing the defined point values puts the model scores at risk of inconsistent scoring and examination selection.

Table 4: TE/GE Has Four Categories and Point Values for Model Queries

Category	Definition	Point value
Automatic	An activity that is a definite significant compliance issue and has significant consequences, such as revocation of tax-exempt status.	10
Speculative	A potential issue that requires investigation to determine if it can be explained by facts and circumstances.	5

<sup>33</sup>We reviewed a generalizable stratified random sample of 114 queries from the Form 990, Form 990-EZ and Form 990-PF models’ population of 354 unique queries and compared the query descriptions with TE/GE’s category definitions. The 95 percent confidence interval is 16.1 to 32.4. Due to the use of queries in identifying noncompliance, we cannot provide text of the queries.

Category	Definition	Point value
Missing Schedule/Form	Schedules or forms (e.g., employment tax) that the Form 990 indicated should be filed but were not filed.	2
Inconsistencies	Reported information by the organization is not consistent with information reported on different parts of the return or with IRS system codes.	1

Source: TE/GE definitions. | GAO-20-454

We found three types of queries involved with the inconsistent assignment of point values.

1. **Miscategorized queries** were not assigned to the category that matches TE/GE’s definition. These occurred because TE/GE has not documented specific rules for query categorization. As a result, we found an estimated 7.4 percent of queries (26 queries) where TE/GE staff overrode the category definitions when assigning points without documenting the reasons.<sup>34</sup> Absent the reasons, TE/GE cannot ensure consistent treatment of similar queries. In our sample, these override decisions included assigning:
  - Three queries to the Speculative category, which is worth five points, when the definitions supported the Automatic category, which is worth 10 points. TE/GE officials said they did this to offset potentially confusing language in the return lines or instructions.
  - One query to the Automatic category rather than the Speculative category supported by the definitions. TE/GE officials said they used the higher point value category to increase the chance of selection so that certain Form 990-PF attachments, which the queries do not cover, would be more likely to be considered for examination.
2. **Queries could fit into more than one category** based on TE/GE’s definitions. We estimate that 16 percent (55) of the queries could fit in more than one category.<sup>35</sup> Of these, 18 in our sample could have been placed in the Missing Schedule/Form category. In addition, we found one query in our sample that TE/GE labeled as having a duplicate but one query was assigned to the Automatic category worth 10 points and the other was assigned to the Inconsistencies category worth one point. TE/GE officials acknowledged that some queries could fit in more than one category. When we asked why certain queries for missing schedules and forms were not categorized as such, these officials described a hierarchy of missing forms based on

<sup>34</sup>The 95 percent confidence interval is 3.3 to 13.8 percent.

<sup>35</sup>The 95 percent confidence interval is 9.4 to 23.5 percent.

being subject to penalties and interest, such as employment tax returns, and their associated categories. They did not document or consistently implement this hierarchy as queries identifying the same missing form sometimes were in different categories.

3. **Sliding scale queries** whose point values differ from those stated in TE/GE's model documentation. We found nine queries with sliding scale point values that involved Form 1099 information returns.<sup>36</sup> The sliding scales reduce point values based on the severity of the compliance issue, such as reducing the query point values if the organization filed a low number of information returns. TE/GE did not provide documentation about the rationale and associated definitions for these queries. Without documentation on the different treatment of these queries, TE/GE is not transparent about the rationale for assigning points through a sliding scale to support its model scoring.

TE/GE officials said they have not updated definitions and criteria for using the categories and sliding scales because of a decision to keep the model operating as is and to update documentation as time permits. After our preliminary analyses, TE/GE provided updated definitions for the four categories, and descriptions of the sliding scales that were used for queries. However, these definitions and descriptions do not include any decision rules or criteria that document how to apply them. Further, the sliding scale descriptions do not offer definitions for words like "low," when referring to the volume of information returns filed.

Definitions that are incomplete and not always followed when assigning point values raise concerns about consistency and transparency in scoring returns for examination selection. TE/GE's assignments affect scores and whether a return is placed on the MSS for examination consideration. Inconsistent or invalid assignment of point values may distort the potential for examination. For example, of the nine miscategorized queries we analyzed in our sample, we determined that if their categorizations were corrected, hits on three of the queries would make a return eligible for the MSS and hits on two others may make a

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<sup>36</sup>TE/GE officials confirmed that these were the only queries in the population that use the sliding scale. Certain exempt organizations must file certain information returns. For example, an organization that pays at least \$600 in a year for services from a non-employee must file Form 1099-MISC, *Miscellaneous Income* to report the payment.

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return eligible, depending on the other queries the return hit.<sup>37</sup> Changes to two queries would have made returns no longer eligible for the MSS.

### **Query Documentation Has Errors That Forestall Valid Analysis of Queries**

We estimate that about 27 percent (96 queries) of the queries in the models had errors in the documented descriptions.<sup>38</sup> Query descriptions detail the logic and data used from specific forms and line numbers that the queries scan. The errors we found include:

- references to older versions of the forms as well as omissions of form lines used in the query; and
- query descriptions that did not match programming code.<sup>39</sup>

To address these differences, TE/GE proposed corrections to the query descriptions. A TE/GE official said re-visiting the query documentation is part of the contractor's 2020 study and that TE/GE does not have a timeline for correcting the documentation.

In addition to errors, the descriptions also use inconsistent language, which prevents easy identification of queries by issue. For example, to identify all queries related to excess benefit transactions, one must manually search different fields for terms such as "excess benefit,"

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<sup>37</sup>The nine queries were in our sample, and part of the estimated 26 miscategorized queries in the population. Two of the five queries should have been categorized as Speculative rather than as Inconsistencies, which would make the return eligible for the MSS. Changes to the other two queries of the nine would have been less likely to affect MSS eligibility.

<sup>38</sup>The 95 percent confidence interval is 21.1 to 33.3. Some queries appear in more than one model, and TE/GE modified query line references to accommodate differences between the forms. For some queries in our sample that are in more than one model, the errors we identified only affect the descriptions in one model. Because our unit of analysis was a query, if we found an error with the query, we counted the entire query as an error.

<sup>39</sup>We reviewed the programming code for the queries in our sample. We shared with TE/GE queries where the descriptions did not match the programming code.

“excessive benefit,” and “EBT” (excess benefit transaction).<sup>40</sup>

Furthermore, TE/GE’s database fields only capture one issue per query. Since many queries involve multiple issues, these fields cannot be used to fully inventory the queries.

These errors and inconsistencies in the query descriptions occurred because TE/GE has no procedures for regular reviews of queries as forms or laws change. TE/GE Compliance Governance Board (Governance Board) members review query descriptions prior to implementation but do not review details of the queries in the context of the entire model.<sup>41</sup> Further, TE/GE procedures only require review of programming code before queries are sent to the Governance Board. Review of the code once it is integrated into the model program is optional, according to TE/GE procedures.

The errors and inconsistent descriptions prevent TE/GE from having a comprehensive and accurate inventory of queries within and across models. Without regular reviews, TE/GE cannot be assured that its programming code is correct and that any analyses of the performance of queries or the models as a whole are valid.<sup>42</sup> When we asked about the lack of regular reviews of queries, TE/GE officials said they plan to implement reviews but did not provide us with a plan or timeframes for doing so.

Another effect of not having a comprehensive and accurate inventory is that TE/GE cannot analyze query performance and identify queries that look for the same compliance issue to prevent redundancies and to ensure valid and consistent scoring. As a result, we found queries that address the same or similar issues with the same criteria, inflating scores for returns and making selection for examination more likely. Our analysis

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<sup>40</sup>An excess benefit transaction is a prohibited transaction in which an economic benefit is provided by an applicable tax-exempt organization, directly or indirectly, to or for the use of a disqualified person. This occurs if the economic value of the benefit provided by the organization exceeds the value received by the organization. Disqualified persons include foundation managers, substantial contributors and their family members. 26 U.S.C. § 4958(c)(1), (f)(1).

<sup>41</sup>We reviewed documentation from a sample of 36 of the 104 new Form 990 queries for the fiscal year 2018 model. In general, TE/GE provided documentation to show management and Governance Board approval of the queries.

<sup>42</sup>We reviewed the programming code for the queries in our sample and, in general, we found it to be accurate.

of the July 2019 Form 990 model run showed 90 pairs of queries, involving 78 unique queries that hit together at least 90 percent of the time. By having two queries that rely on the same criteria, returns accumulate extra points for the same behavior. For example, all 910 returns that hit an employment tax query also hit a query that shares some of the same criteria and thresholds. As a result, these returns accumulated 10 points rather than five points, making them eligible for the MSS. Aside from our sample, we found queries seeking certain organizations with political campaign activities and political expenditures that would total 15 points in the Form 990 model.<sup>43</sup> Queries identifying these same activities and expenditures would total 30 points in the Form 990-EZ model.

TEGE's contractor recommended in 2018 that TE/GE eliminate "redundant" queries, which is similar to our finding. TE/GE officials said they do not believe the redundant queries are duplicates and they are awaiting the results of the contractor's study in 2020 before making changes. Until TE/GE resolves the extent to which it has redundant queries, it cannot do a valid analysis of whether its queries identify the most noncompliant returns.

### **TE/GE Lacks Procedures and Criteria for Testing Proposed Model Queries**

TE/GE has no procedures requiring the testing of proposed model queries. Even so, based on our sample of the new queries in the fiscal year 2018 Form 990 model, TE/GE would be able to provide evidence of tests for an estimated 94 percent of all new queries.<sup>44</sup> However, TE/GE also does not have procedures for how to conduct testing or what data to use. The testing that has been performed consisted of running the query on certain tax years of returns to count the number of returns flagged, according to a TE/GE official. TE/GE does not run the queries on data from closed examinations to see whether the queries would identify known compliance issues that justify an examination. Interactions with existing queries are not tested. When considering new queries, Governance Board members see the number of returns flagged by each

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<sup>43</sup>One of the queries was also miscategorized and should have been worth 10 points rather than five.

<sup>44</sup>The 95 percent confidence interval is 75.9 to 97.6. We selected these 36 new queries in our generalizable sample, which might be considered a small sample size in some context. Because the population size is small (104), we present generalizable estimates along with the sample number of observations.

query during testing, but have no criteria to determine whether a query flags an appropriate number of returns. A TE/GE official said TE/GE does not believe it needs to document procedures for testing.

In the absence of procedures and standards, TE/GE cannot ensure that testing of new queries is done consistently with appropriate data sources and research standards. By only testing the number of returns that a query flags, TE/GE cannot validate that proposed queries can effectively identify the noncompliance that would be worth examining. Using tested, validated and documented data is a critical step in ensuring that research is proper, reliable, and accomplished in accordance with expectations, according to the IRM.<sup>45</sup> Without testing queries on reliable data, and making adjustments based on criteria, TE/GE risks implementing queries that do not produce reasonable numbers of hits that are worth pursuing through examinations.

#### TE/GE Did Not Fully Document Its Processes for Transforming Data into Quality Information for Other Examination Sources

For examination sources that used data other than the models, we found that TE/GE did not always document its processing of data into quality information.<sup>46</sup> We identified common “start-to-finish” segments to this processing of data, including:

- submitting a proposal and supporting data to find noncompliance;
- reviewing the potential data sources and queries or thresholds to be used as examination selection criteria; and
- recommending the proposed effort for approval through the appropriate executives.

On one hand, TE/GE provided documentation of the required approvals for these segments in processing data for five compliance strategies.<sup>47</sup> These strategies included examining loans by private foundations and collecting information on organizations that exceed investment income limitations.

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<sup>45</sup>IRM Part 1, Chapter 7, Section 1.

<sup>46</sup>We focused on examination sources that rely on data for selection, such as compliance strategies, models and projects that use queries. See appendix I for details on our scope and methodology.

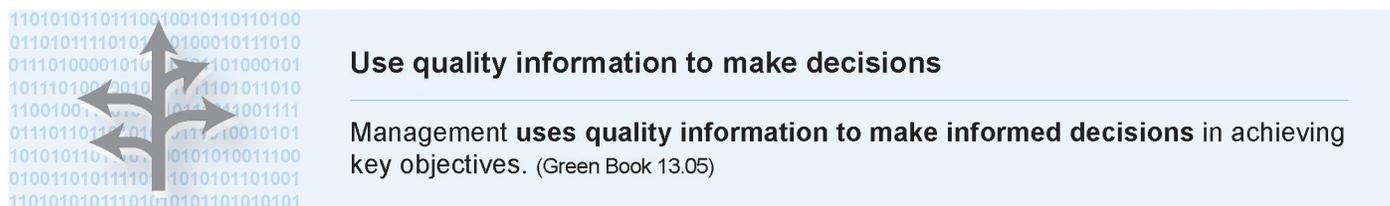
<sup>47</sup>We requested examples and TE/GE provided five compliance strategies.

On the other hand, TE/GE did not provide similar start-to-finish documentation on processing quality information from other examination sources that use data outside of the models; examples include research projects under the Data Driven Approaches portfolio and projects that use queries under the Referrals and Other Casework portfolio (see table 1). Over several discussions, TE/GE did not explain why it did not fully document such projects. By not fully documenting how it processes data into quality information, and by not linking such processes to measurable objectives, TE/GE cannot ensure that it is analyzing quality information in selecting examinations.

**TE/GE Did Not Consistently Document Use of Quality Information to Make Decisions**

For the compliance strategies, TE/GE showed evidence of using the quality information to decide which returns to select for examination, such as for Governance Board decisions. However, TE/GE did not provide documentation on how it made selection decisions using data for other projects that use queries (see figure 8).

**Figure 8: Step 4**



Source: GAO. | GAO-20-454

In addition, TE/GE did not use quality information to decide how frequently to run the model. TE/GE decided to run the Form 990 models twice per year without analyzing the effects. Moreover, we found that the time between runs is inconsistent.<sup>48</sup> Since the Form 990 model's first run, the time between runs ranged from 84 days to 251 days.<sup>49</sup> Since returns are ranked on the MSS, eliminations result in the classification staff selecting lower scoring returns. The average score for examined returns

<sup>48</sup>A TE/GE official said runs have been delayed for various reasons, such as programming issues.

<sup>49</sup>The 251 days is the number of days between the October 2018 and the July 2019 model runs. As of January 2020, TE/GE has not run the model since July 2019.

was 27.1 for the list that was used for 84 days compared to 23.2 for the list used for 251 days.

To the extent that TE/GE ensures that its model scores are as reliable and valid as possible, analyzing data could help TE/GE identify the frequency of model runs that maximizes the use of model scores to guide decisions on examination selection. For example, analyzing Form 990 filing patterns could help identify the optimal timing of model runs, allowing for adequate time remaining under the statute of limitations.<sup>50</sup>

### Lack of Regular Evaluations and Inconsistent Data Prevent TE/GE from Fully Evaluating Its Selection Methods

TE/GE does not regularly evaluate its models and other selection processes that use data. In particular, model scores for all returns are not retained or are inconsistent from year to year which limits the ability to conduct evaluations. Furthermore, TE/GE does not evaluate reasons why some selected returns are not examined, which could help improve selection methods (figure 9).

Figure 9: Step 5



#### Evaluate outcomes and use lessons to improve process

Management evaluates performance (outcomes) for key objectives and takes actions to remediate deficiencies. (Green Book 13.05.,16.03, and 17.06)

Source: GAO. | GAO-20-454

### TE/GE Has No System for Regularly Evaluating Examination Selection Decisions

TE/GE has not regularly evaluated its examination selection decisions that rely on data to improve its selection methods. While TE/GE commissioned the contractor evaluations of its Form 990 model, it has no documented process for continued evaluations of the model or any evaluations of other sources, such as research projects, that rely on data to select returns for examination. For its compliance strategies, not

<sup>50</sup>Most Form 990s are filed by May 15 each year, according to TE/GE officials. Electronically filed returns are available for model runs about 2 weeks after filing and paper returns are available after 3 to 4 weeks, according to TE/GE officials.

enough examinations have closed under the strategies to warrant evaluations yet, according to a TE/GE official.

Data limitations have challenged evaluation efforts, according to a TE/GE official. To address this, TE/GE started capturing more detailed data on examination outcomes; however no evaluations of outcomes have resulted. The officials noted that they have been spending more time reporting and monitoring compared to analyzing and evaluating, which they said needs to occur more often. Without evaluation, TE/GE cannot ensure that its use of data to select returns is working as intended.

In addition to not evaluating selection decisions and their outcomes, TE/GE has also not addressed the Form 990 model deficiencies the contractor previously identified. In its 2018 reports, the contractor made 17 recommendations (see appendix V for the status of each recommendation). A TE/GE official said it had not acted on many recommendations because all examination selection strategies are being evaluated with the transition to the Compliance Planning and Classification (CP&C) office. TE/GE initiated another study in 2019 with the same contractor to address its 2018 recommendations among other tasks. As of March 2020, TE/GE implemented one recommendation and part of another, deferred action on nine recommendations until after the contractor finishes the new study, deferred action on three due to other reasons, and did not clearly provide a status for two. In addition, TE/GE will likely not implement the other recommendation.

According to contract documentation, the study will explore architectures and alternative designs to the model, propose up to three compliance actions other than examinations, and recommend measures to monitor the actions' effectiveness. TE/GE expects a final report by September 2020. To the extent that TE/GE has not implemented the contractor's recommendations from 2018, the related deficiencies identified in the Form 990 model will have persisted for more than 2 years by the time the contractor issues its 2020 report. Unless TE/GE documents its consideration and action of the recommendations, the value of the contractor's work is diminished and possible improvements may be overlooked.

### **TE/GE Has Not Retained Complete Data to Allow for Full Evaluation of Its Models**

Until recently, TE/GE did not retain model scores for each return and query performance data that would be useful for evaluation. The January

2018 contractor report recommended that TE/GE save model data. For its July 2018 report, the contractor had to recreate historical scoring data for its evaluation. TE/GE officials said they increased storage space and saved the fiscal year 2018 data. When we asked for these data, TE/GE officials said that each time they run a model, they overwrite the old data. The officials said they did not have space on their server to save all of the data. Instead, TE/GE had been saving the MSS's for each run. However, the MSSs have only limited value for evaluating the model and queries. Specifically, the MSS for each model run contains score information for only about 20,000 returns (out of about 300,000 scored) that have a certain minimum score and hit queries in certain categories. Further, the MSS does not contain data on model queries that are flagged.

In September 2019, TE/GE officials said the Research, Applied Analytics and Statistics division provided temporary server storage space to save model data through September 2020 while the contractor assesses TE/GE's models. Starting with the July 2019 model run, TE/GE is saving score and query performance data for all filed returns. In January 2020, TE/GE officials told us they developed a way to save data on query hits for all returns run through the model. However, TE/GE has not provided documentation to show exactly what data will be saved over the long term for all filed returns run through the model. Without complete historical data on model scores and query hits, TE/GE cannot assess the full performance of its models. Such data would facilitate an analysis of the queries, and whether they identified returns with changes or related pick-up returns.

### **Historical Data on Examination Outcomes Lack Consistency, Which Complicates Evaluation**

TE/GE does not analyze consistent multi-year data on examination outcomes, which would facilitate evaluation of its use of data in selecting returns for examination. TE/GE officials said they use historical data—such as change rates—to determine the success of an examination source. TE/GE provided historical data on examination starts, closures, and pick-up returns covering 2 years but did not provide data beyond that

and change rates were not always included.<sup>51</sup> Further, TE/GE has used different methods to organize and report examination outcomes over the years.<sup>52</sup> These differences in reporting outcomes affect TE/GE's data in the following ways:

- Starting with fiscal year 2018, data on exempt organizations examinations include federal, state and local employment tax examinations. Prior to 2018, TE/GE reported these employment tax examination data separately.
- After TE/GEs reorganization in 2017, it grouped examinations into portfolios and changed the portfolio definitions during 2018.

As of March 2020, TE/GE has not produced a consistent method of summarizing of historical data. TE/GE officials acknowledged data limitations, and said they are working to implement recommendations from a 2019 study to improve capturing examination data. TE/GE officials said the staff member analyzing data has been doing so for many years, allowing them to reconcile the data. However, this poses a risk that other IRS or oversight entities cannot reconcile the data. According to internal control standards, agencies should establish effective methods for retaining organizational knowledge and mitigate the risk of having that knowledge limited to a few personnel, as well as contingency plans to respond to sudden personnel changes.

TE/GE's inconsistent data limit its ability to conduct evaluations. These inconsistent data also prevent TE/GE from establishing baselines or targets for examination outcomes such as change rates to help measure the success of its selection methods.

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<sup>51</sup> TE/GE uses data for multiple years to calculate examination hours spent per return and the number of days spent on an examination, as some examinations continue across fiscal years. However, counting days and hours that cross years is different than collecting multi-year trend data. TE/GE did not provide any analysis or decisions made using these data.

<sup>52</sup>For example, fiscal years 2015-2016 data are reported by issue area, and some project codes reported outcomes in more than one area. TE/GE used another system prior to that. Since fiscal year 2018, TE/GE reports by portfolio.

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TE/GE Did Not Evaluate Reasons for Not Examining Some Returns Selected for Examination

In fiscal year 2019, TE/GE did not examine about 20 percent of the exempt organization returns that had been selected for examination.<sup>53</sup> Although this rate of non-examined returns has improved in recent years, TE/GE has not analyzed data to explore why the rate has improved and how to reduce it further.<sup>54</sup>

Our analysis showed that almost 30 percent of these returns were not examined because they were too close to the statute of limitations date. TE/GE officials did not have a reason why the returns were sent to the field for examination if the statute date was so close. TE/GE officials said they do not regularly analyze reasons for non-examined returns. They said they have analyzed only the number of non-examined returns by manager and area. In addition, TE/GE officials said they implemented new guidance in fiscal year 2019 for staff who make decisions to not examine returns, which is intended to improve the information they have on these decisions. As of fiscal year 2019, TE/GE began tracking certain non-examined returns by project code but has not committed to analyzing the data.

Non-examined returns are not an efficient use of resources, as the time spent reviewing and rejecting these returns—even if minimal—reduces the time staff have for conducting examinations. Routinely analyzing reasons for non-examined returns, as well as related data, could help TE/GE identify actions to reduce the number of returns that are sent to the field but are then declined for examination by a manager or examiner.

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<sup>53</sup>A non-examined return was selected for examination but not started or was started but not completed. This includes what IRS calls a “survey.” An examiner or manager may survey an assigned return if he or she determines that the issues to be examined do not have merit or the return is close to its statute of limitations date, among other reasons. Other returns may not be examined because of various inventory management reasons.

<sup>54</sup>Rates were about 24 percent in fiscal year 2016, and 22 percent in 2017 and 2018. The Form 990 model had a 20 percent non-examined return rate in 2018 and 13 percent rate in 2019.

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## Updating Examination Selection Procedures and Identifying Risks Could Help TE/GE Use Data in Decision Making

### TE/GE Has Not Annually Reviewed and Updated Procedures in Certain Internal Revenue Manual Sections or Issued Related Interim Guidance on Examination Selection

TE/GE did not annually update procedures on examination selection and databases in certain IRM sections since the May 2017 reorganization. The Internal Revenue Manual (IRM) states that procedures in IRM sections must be annually reviewed and updated as needed.<sup>55</sup> TE/GE released updated IRM sections for two of the three groups in CP&C. It released a section on the Issue Identification and Research in September 2018, and one on the Classification and Case Assignment procedures in September 2019.<sup>56</sup> However, these sections do not cover the steps the model classifier takes when reviewing returns from the MSS. As of December 2019, no IRM section has been released on the Planning and Monitoring group. As such, TE/GE staff does not always have official information on roles and responsibilities for new entities and processes created since May 2017.

For certain updated or new IRM sections, TE/GE did not release interim guidance while those sections awaited approval. IRS requires issuance of interim guidance to address deviations from the IRM, even if temporary.<sup>57</sup> Instead of developing interim guidance, TE/GE officials stated that, in the wake of the reorganization, they decided to use desk guides, such as for the IRM section on classification and case assignment processes. However, TE/GE did not update its desk guides on processes until more than 2 years after the reorganization. Furthermore, the desk guides do not cover the specific duties of the model classifier, or the steps for classification of returns identified for compliance strategies.

IRM guidance states that management must develop and maintain documentation on data systems; collection and analysis; and responsibilities for data collection, input and analysis. Timely documentation of new procedures and responsibilities improves the

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<sup>55</sup>IRM Part 1, Chapter 11, section 10.

<sup>56</sup>IRM Part 4, Chapter 70, sections 5 and 6.

<sup>57</sup>IRM Part 1, Chapter 11, section 2.

accuracy and reliability of IRM content. According to the IRM, when the IRM and related guidance are not current, TE/GE increases the risk that staff follow incorrect procedures, use guidance that is not transparent to the public, administer tax laws inconsistently, and misinform taxpayers.

### TE/GE Has Not Identified Risks from Using Data for Examination Selection

Good federal government practice requires risk management, without which, TE/GE could undercut its use of data to enhance decisions on examination selection.<sup>58</sup> Although the use of data in examination selection has the potential to improve efficiencies in classifying and examining returns to identify noncompliance, any new endeavor carries risks.

TE/GE did not identify any TE/GE-specific risks that could undercut its success in using data to select exempt organization returns for examination. As of December 2019, the TE/GE risk register identified 12 risks, ranging from aging technology and infrastructure to employee engagement and morale. One risk— data access and analytics—involved using data in general decision making at the IRS level rather than TE/GE decisions about examination selection or its related models. TE/GE officials said they are analyzing and responding to this risk under the IRS-wide risk management process.

TE/GE did not document why it did not identify any TE/GE-specific risks in using data for examination selection. Our report discusses a number of deficiencies that could be potential risks to TE/GE using data in selecting returns for examination. For example, TE/GE lacks program objectives that would be necessary to identify and assess risks. We also found weaknesses in how TE/GE processes and analyzes data to inform examination selection and how it evaluates selection decisions. Further, the IRM states that TE/GE's Compliance Governance Board (Governance Board) should consider risks in its decisions and we saw that risks were considered in documents proposing examination selection criteria to the Governance Board. We did not find evidence that TE/GE's risk

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<sup>58</sup>Risk management relies on having measurable objectives to identify and assess risk to those objectives. Under Green Book criteria, an entity should: (1) define risk tolerances (i.e., the acceptable level of variation in performance in achieving objectives) in specific and measurable terms; (2) consider internal and external factors to identify risks; (3) analyze identified risks to estimate their significance for responding to the risks; and (4) design specific actions to respond to the analyzed risks.

management process recorded these risks for analysis and any response if needed.

After we shared our concerns about the lack of identified risks, TE/GE officials noted that TE/GE participates in mitigation steps as identified by the IRS Risk Office. TE/GE officials also mentioned CP&C representation in an IRS pilot program designed to explore ways to better select employment tax cases. While such actions could be a component of a risk management strategy, it is incomplete and it is unclear how this initiative would help TE/GE identify, analyze, and mitigate risk.

Not identifying and managing risks identified in this report leaves TE/GE open to errors and examination selection decisions that are potentially not transparent or not fair. As such, without objectives and a consistent and documented process for identifying and managing risks, TE/GE cannot effectively address risks that may hamper its efforts to use data to enhance its compliance work.

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## Conclusions

Increasingly constrained resources underscore the importance of TE/GE's efforts to efficiently identify and examine exempt organization returns that have the highest noncompliance potential. TE/GE has developed ways to use data to aid in examination selection. However, opportunities exist to strengthen internal controls to help ensure that data used are reliable, decision rules are clear and documented, and objectives are identified and being achieved.

TE/GE should take several steps to improve the reliability and validity of the models. These steps include improving documentation of decision rules and criteria for scoring; regularly reviewing model documentation and programming; testing new queries and their interaction with existing queries; retaining model and query data; and periodically evaluating the performance of selection methods.

In absence of regular evaluation of its examination selection decisions, TE/GE misses opportunities for improving its selection processes. Deficiencies that TE/GE's contractor already identified provide an opening for improving its models. Without consistent historical data, TE/GE will be limited in assessing progress and making improvements. A review of the reasons why certain returns selected for examination are not examined is

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an example of an evaluation that could help inform process improvements.

Ensuring that all procedures are current and accurate would reduce the potential for employees following incorrect procedures and administering tax laws inconsistently. TE/GE's lack of identified risks from using data in examination selection precludes TE/GE from analyzing and responding to those risks. By taking actions to further strengthen these internal controls, TE/GE could enhance its efforts to identify and examine the most noncompliant exempt organizations and enhance IRS's oversight of tax exempt organizations and help maintain the integrity of the charitable sector and the larger exempt community.

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## Recommendations for Executive Action

We are making the following 13 recommendations to IRS:

The Commissioner of Internal Revenue should document measurable objectives for using data in selecting exempt organization returns for examination. (Recommendation 1)

The Commissioner of Internal Revenue should document and consistently use clear criteria and decision rules on assigning point values to queries, using categories and sliding scales. (Recommendation 2)

The Commissioner of Internal Revenue should require a regular review of query descriptions and programming to ensure their accuracy and minimize queries that flag the same or similar compliance issue. (Recommendation 3)

The Commissioner of Internal Revenue should develop procedures and criteria to test new queries prior to implementation in the models. (Recommendation 4)

The Commissioner of Internal Revenue should more fully document how TE/GE processes data and uses data to make examination selection decisions for sources outside of the model such as research projects and other projects that use queries. (Recommendation 5)

The Commissioner of Internal Revenue should conduct an analysis to identify the optimal interval between model runs. (Recommendation 6)

The Commissioner of Internal Revenue should establish a process for regularly evaluating selection decisions and related outcomes for the models and other processes that use data to select returns for examinations. (Recommendation 7)

The Commissioner of Internal Revenue should document consideration or action on recommendations from its 2018 and 2020 contractor assessments. (Recommendation 8)

The Commissioner of Internal Revenue should document how score and query data for all returns in the models will continue to be saved over the long term. (Recommendation 9)

The Commissioner of Internal Revenue should ensure that historical data on examination outcomes are consistently defined and used when doing analysis of examination outcomes. (Recommendation 10)

The Commissioner of Internal Revenue should routinely analyze the reasons for not examining selected returns and identify any necessary actions to address the reasons. (Recommendation 11)

The Commissioner of Internal Revenue should annually review and update procedures as needed in relevant IRM sections on examination selection and issue interim guidance until the affected IRM sections are updated. (Recommendation 12)

The Commissioner of Internal Revenue should document why TE/GE has not identified any risks in its risk register for using data to select exempt organization returns for examination. If risks are subsequently identified, TE/GE should document how it plans to analyze and address them. (Recommendation 13)

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## Agency Comments and Our Evaluation

We provided a draft of this report to IRS for review and comment. IRS provided written comments, which are reproduced in appendix VI and summarized below. Of our 13 recommendations, IRS agreed with 12 and disagreed with one. IRS also provided technical comments, which we incorporated as appropriate.

IRS disagreed with our recommendation on ensuring that historical data on examination outcomes are consistently defined (Recommendation 10), pointing out that its raw data are consistently defined in its information

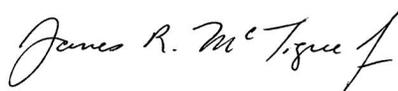
systems. Our concern, however, is with how the outcome data are reported and analyzed, which inhibits understanding of outcome trends over time. In response to IRS comments, we added language to the final recommendation to more clearly focus on the consistency of the outcome data used and analyzed over the years.

In addition, although IRS agreed with our recommendation to more fully document how TE/GE processes and uses data to make examination selection decisions outside of the model (Recommendation 5), IRS said that it would provide documentation on a project (other than compliance strategies) that is approved by the Governance Board. While we look forward to such documentation, we are primarily interested in IRS documenting a system for how it processes and uses data to select returns for examinations for projects outside of the model, regardless of Governance Board approval. As discussed in the report, IRS has such a system for projects in its compliance strategies portfolio, which could provide a framework to follow.

Similarly, IRS agreed to analyze return due dates of the filing populations commonly associated with the examinations (Recommendation 6). We will be interested to see how that analysis helps IRS to determine the optimal interval between model runs, which is the focus on our recommendation.

We are sending copies to the appropriate congressional committees, the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. In addition, this report is available at no charge on the GAO website at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact me at (202) 512-9110 or [mctiguej@gao.gov](mailto:mctiguej@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix VII.



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# Appendix I: Objectives, Scope, and Methodology

This report assesses (1) the use of data to select tax-exempt organization returns for examination; and (2) the process the Tax Exempt and Government Entities (TE/GE) division has established to select returns for examination.

To assess the use of data to select tax-exempt organization returns for examination, we reviewed data from the Internal Revenue Service's (IRS) Returns Inventory and Classification System (RICS) for fiscal years 2016 to 2019.<sup>1</sup> Table 5 defines the variables and measures we analyzed.<sup>2</sup>

**Table 5: Examination Measures Analyzed**

Measure	Definition
Closures	Number of examinations closed in a fiscal year.
Starts	Number of examinations started in a fiscal year.
Change rate	Percentage of closed examinations that resulted in a change to the return. In general, a higher change rate indicates resources are being spent examining noncompliant entities.
Non-examined return rate (also survey rate)	Percentage of returns selected for examination but not started or started but not completed. Examiners or managers may "survey" an assigned return if they determine that the issues to be examined do not have merit or the return is close to its statute of limitation date.
Pick-up rate	Percentage of returns examined that were not the original return selected for examination. During examination of the original selected return, an examiner may "pick up" another year's return or another form if they identify compliance issues. Examiners may also prepare a substitute for return (SFR), or a "dummy" return if an organization did not file a required return. SFRs are included in the pick-up rate.
Weighted disposal score	When an examination is closed, an examiner assigns a disposal code that indicates the action taken. TE/GE assigned weights to rank the severity of the disposal codes, on a scale of one (least severe) to 10 (most severe).

<sup>1</sup>TE/GE uses RICS to examine tax filing compliance, access tax-filing data, and track examination outcomes.

<sup>2</sup>Analysis of each measure is not included in the report. Since TE/GE could not fully explain the rationale behind the weighting used in the weighted disposal score measure, we do not report those results. To understand resources invested in TE/GE's models, we reviewed average case grades of examinations by project code and average hours per return by project code. We did not find meaningful differences.

**Appendix I: Objectives, Scope, and Methodology**

<b>Measure</b>	<b>Definition</b>
Average case grade of examiner	Examinations are assigned a case grade based on the complexity of the issues, or characteristics of the examined organization. An examiner’s grade is based on his or her work experience. Higher graded examiners work more complex and higher grade examinations.
Average hours per return	Average number of hours the examiner spent conducting an examination.
Average tax dollars assessed	Employment, excise or other tax amounts assessed after examinations, excluding assessed tax amounts that were refunded or credited to a taxpayer.

Source: GAO analysis of IRS documents. | GAO-20-454

We analyzed aggregated data at the project code level, and we grouped project codes by examination source (for example, examinations from referrals occurred under several project codes).<sup>3</sup> Based on our testing of the data and review of documentation and interviews, we determined that the data were reliable for purposes of assessing TE/GE’s selection processes.

We analyzed outcomes from the Form 990, *Return of Organization Exempt from Income Tax* model.<sup>4</sup> We used RICS data and Model Score Sheets (MSS), for examinations closed from October 1, 2015 through September 30, 2019.<sup>5</sup> Each model run generates an MSS, which is a ranked list of Form 990s that hit certain types of queries and have a minimum score.<sup>6</sup> We matched Form 990 scores from the MSS with selection information and examination outcomes in RICS for examinations closed under all project codes, though the data presented in objective one is specific to examinations started under the Form 990 project code.<sup>7</sup> We used source codes—which indicate whether an examination was a pick-up, substitute for return or primary return—to analyze what types of examinations produced the highest change rates under the Form 990 model project code. To inform this work, we reviewed recent TE/GE contractor assessments of exempt organization examination selection and the Form 990 model.

<sup>3</sup> TE/GE reviewed our groupings of project codes.

<sup>4</sup>The Form 990 model is a set of queries that identify potential noncompliance using the taxpayer’s responses. TE/GE has other models, but we focused on the Form 990 model because it affects the most returns.

<sup>5</sup>TE/GE first ran the Form 990 model in October 2015.

<sup>6</sup>Each return receives a model score based on the accumulated point values for all its query hits.

<sup>7</sup>Some returns that were ranked highly on the MSS may be examined under another project code.

To assess the process that TE/GE has established to select returns for examination, we reviewed internal controls steps in Standards for Internal Control in the Federal Government (Green Book).<sup>8</sup> Given TE/GE’s emphasis on using data in examination selection, we identified five internal control steps related to analyzing data to select returns for examination to address our objectives.<sup>9</sup> We selected four other internal controls because they constitute practices common to all five steps in the selection process. These are presented in table 6.

**Table 6. Selected Internal Controls for Analyzing Data Used to Determine Which Returns to Examine**

Internal Control Type	Criteria
<b>5 Steps</b>	
1. Establish Measurable Objectives for Decision Making	Define objectives in measurable terms so performance in achieving objectives can be assessed. (Green Book (GB) 6.04)
2. Access Relevant Data from Reliable Sources	Obtain relevant data from reliable internal and external sources in a timely manner based on identified information requirements. (GB 13.04)
3. Process Data into Quality Information	Process the obtained data into quality information that supports the internal control system (i.e., using data in decision making); use quality information to achieve the entity’s objectives; and document policies on the responsibilities for data collection, input, and analysis. (GB 13.05, 13.01, and 12.02)
4. Use Quality Information to Make Decisions	Use the quality information to make informed decisions in achieving key objectives. (GB 13.05)
5. Evaluate Outcomes and Use Lessons to Improve Process	Evaluate performance (outcomes) for key objectives and take actions to remediate deficiencies. (GB 13.05, 16.03, and 17.06)
<b>Other Internal Controls</b>	
A. Documents Procedures and Process	Develops, maintains, and updates in a timely fashion documentation on the responsibilities for data collection, input and analysis for using data in decision making. (GB 12.02 and 12.05 and IRM)
B. Risk Management	Defines risk tolerances in specific and measurable terms, considers internal and external factors to identify risks, analyzes risks to estimate significance, and designs specific actions for response. (GB 6.09, 7.04, 7.05, and 7.09)
C. Competence Assessment	Ensures that personnel possess competence to meet responsibilities as well as understand the importance of effective data analysis in decision making. (GB 4.04)

<sup>8</sup>GAO, *Standards for Internal Control in the Federal Government*, [GAO-14-704G](#) (Washington, D.C.: Sept. 10, 2014). The Green Book refers to “principles” and “attributes” when enumerating internal controls. We cite these concepts here as well, but will use “internal controls” for the sake of simplicity.

<sup>9</sup>The Green Book applies to any federal agency; we adjusted the language where necessary to focus on TE/GE’s use of data in examination selection. As such, the language in entries in the second column of table 6 does not always exactly match that in the Green Book.

**Appendix I: Objectives, Scope, and Methodology**

<b>Internal Control Type</b>	<b>Criteria</b>
D. Communication Inside and Outside Division	Communicates necessary information to enable personnel to perform key roles for analyzing data in decision making and with external parties. (GB 14.03 and 15.20)

Source: GAO analysis of internal control criteria and IRM. | GAO-20-454

To identify criteria specific to IRS, we reviewed the Internal Revenue Manual (IRM), which provides standards and guidance similar to the criteria we identified.<sup>10</sup> We shared the Green Book and IRM criteria with TE/GE, as well as our expectations of the documentation that would show adherence to these criteria.

Our assessment focused on examination sources developed after the 2017 reorganization and sources that rely on data for selection (such as models and projects that use queries). Examination sources that did not rely on data, such as claims, were not assessed. We reviewed the referrals classification process to consider how data might be used to enhance it. We analyzed TE/GE documents such as Program Letters, Business Performance Reviews, desk guides, memorandums, work plans, performance data, contractor reports and training documents.<sup>11</sup> In addition, we assessed documents—such as meeting minutes and research results—showing the development and approval of data queries and projects used in examination selection. We reviewed the MSSs for the Form 990 model, and procedures for the Form 990 model, the Form 990-EZ, *Short Form Return of Organization Exempt from Income Tax*, and Form 990-PF, *Return of Private Foundation*, models.<sup>12</sup>

We selected a generalizable stratified random sample of 114 of the 354 unique queries in the three models (see table 7).

**Table 7. In Scope Population and Sample Counts of Queries within Each Stratum**

<b>Strata/Model</b>	<b>Population Count</b>	<b>Sample Size</b>
1. Certainty (Form 990-PF)	31	31
2. Both Form 990 and 990-EZ	94	26

<sup>10</sup>The IRM is IRS’s official source of guidance.

<sup>11</sup>The TE/GE Program Letter describes compliance priorities and plans at the start of each fiscal year. Business Performance Review documents are quarterly reviews of a variety of topics including organizational performance, key issues, risks, budget, staffing, and other considerations as applicable.

<sup>12</sup>TE/GE also has a model for Form 5227, *Split Interest Trust Information Return*. We did not analyze this model, as examinations resulting from the model were not expected to start until fiscal year 2020.

**Appendix I: Objectives, Scope, and Methodology**

<b>Strata/Model</b>	<b>Population Count</b>	<b>Sample Size</b>
3. Form 990-EZ only	81	18
4. Form 990 only	148	39
<b>Total</b>	<b>354</b>	<b>114</b>

Source: GAO analysis. | GAO-20-454

Note: After selecting the sample, we removed 22 queries because they were determined to be out of scope (21 queries in stratum 4 were “study” queries that are not used in scoring, of which seven were sampled) or duplicative of another query (one query in stratum 3). This resulted in the in scope population and sample listed in this table.

Because we followed a probability procedure based on random selections, our sample is only one of a large number of samples that we might have drawn. Since each sample could have provided different estimates, we express our confidence in the precision of our particular sample’s results as a 95 percent confidence interval (e.g., the margin of error is +/- 10 percentage points). This is the interval that would contain the actual population value for 95 percent of the samples we could have drawn. Our sample is designed to control the margin of error of attribute estimates within the overall scope query sample as well as the combined Form 990 query sample (a combination of strata 2 and 4 plus certainty selections). The sample was designed as follows.

- There is one certainty stratum for Form 990-PF queries where we selected a 100 percent sample (i.e. a census), and this stratum does not have a margin of error.<sup>13</sup> We selected these queries with certainty because of the smaller population size in this stratum.
- For remaining strata, we selected the necessary sample size to achieve an overall 95 percent confidence interval for attribute (percentage) estimates with a margin of error of about +/-10 percentage points under proportionate allocation. In addition, the sample size was increased in strata 2 and 4 (combining Form 990 model queries) to achieve the necessary sample size for a 95 percent confidence interval with a margin of error of about +/-10 percentage points within this group.

For the sampled queries, we compared their category and descriptions as provided in the model documentation, with TE/GE’s definitions of the categories to assess whether the query was categorized appropriately. We also compared the query descriptions with the forms to assess whether the referenced lines were relevant to the query. Additionally, we

<sup>13</sup>A probability sample from a population is one that is selected by some random method such that each item in the population has a known, nonzero probability of being drawn that can be calculated. A certainty stratum contains items selected with probability equal to one (i.e. a census).

reviewed the model programming code to check for errors and consistency with the query descriptions. For query categorizations that did not match TE/GE's definitions or queries that appeared to have errors in the descriptions or programming, we asked TE/GE to review and explain its decisions. To identify potentially redundant queries, we analyzed output from the July 2019 Form 990 model run, the only one available at the time of our analysis.

Within our sample, we reviewed 36 of the 104 newly added queries in the fiscal year 2018 model.<sup>14</sup> Specifically, we reviewed approval documentation and meeting minutes to test whether two levels of management and the Compliance Governance Board approved new queries, consistent with TE/GE procedures. We also reviewed evidence that TE/GE tested each query prior to its approval for inclusion in the models.<sup>15</sup>

We held two telephone focus groups with the nine classifiers who review exempt organizations referrals.<sup>16</sup> We asked questions about the data and resources they use to classify referrals, how they convey their results, and how they are provided feedback. We interviewed officials from the Compliance Planning and Classification office and IRS's Research, Applied Analytics and Statistics division who worked on several compliance research initiatives. We met regularly with TE/GE to share ongoing assessments.

We conducted this performance audit from November 2018 to June 2020 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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<sup>14</sup>The sample design allocated the sample across each model as described in table 7 (Form 990, 990-EZ and 990-PF), and these align with whether the query was new or old, as of fiscal year 2018. Table 7 includes 104 new queries in the Form 990 model of which 10 were in stratum 1 (all 10 were selected in our sample) and 94 are in stratum 2 (26 were selected in the sample).

<sup>15</sup>TE/GE procedures do not require testing of new queries, but such testing falls under Step 3 of the internal controls we reviewed and the IRM.

<sup>16</sup>We did not report any findings from these groups.

Appendix II: Form 990, Return of Organization Exempt from Income Tax

# Appendix II: Form 990, Return of Organization Exempt from Income Tax

The figure below shows the text of the 2019 version of Form 990, Return of Organization Exempt from Income Tax. A list of schedules for the Form 990 is provided in table 8 following the form.

Figure 10: Form 990, Return of Organization Exempt from Income Tax

**Form 990** Return of Organization Exempt From Income Tax

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**2019**  
Open to Public Inspection

Under section 501(c), 527, or 4947(a)(1) of the Internal Revenue Code (except private foundations)  
Do not enter social security numbers on this form as it may be made public.  
Go to [www.irs.gov/Form990](http://www.irs.gov/Form990) for instructions and the latest information.

**A** For the 2019 calendar year, or tax year beginning 2019, and ending 20

**B** Check if applicable:  
 Address change  
 Name change  
 Initial return  
 Final return/terminated  
 Amended return  
 Application pending

**C** Name of organization  
 Doing business as  
 Number and street (or P.O. box if mail is not delivered to street address) Room/suite  
 City or town, state or province, country, and ZIP or foreign postal code

**D** Employer identification number  
**E** Telephone number

**F** Name and address of principal officer:  
 H(a) Is this a group return for subsidiaries?  Yes  No  
 H(b) Are all subsidiaries included?  Yes  No  
 If "No," attach a list. (See instructions)

**G** Gross receipts \$  
 M(e) Group exemption number ▶

**I** Tax-exempt status:  501(c)(3)  501(c) ( ) (insert no.)  4947(a)(1) or  527

**J** Website: ▶

**K** Form of organization:  Corporation  Trust  Association  Other ▶

**L** Year of formation: **M** State of legal domicile:

**Part I Summary**

**1** Briefly describe the organization's mission or most significant activities:

**2** Check this box  if the organization discontinued its operations or disposed of more than 25% of its net assets.

Activities & Governance		
<b>3</b> Number of voting members of the governing body (Part VI, line 1a)	3	
<b>4</b> Number of independent voting members of the governing body (Part VI, line 1b)	4	
<b>5</b> Total number of individuals employed in calendar year 2019 (Part V, line 2a)	5	
<b>6</b> Total number of volunteers (estimate if necessary)	6	
<b>7a</b> Total unrelated business revenue from Part VIII, column (C), line 12	7a	
<b>7b</b> Net unrelated business taxable income from Form 990-T, line 39	7b	

Revenue	Prior Year	Current Year
<b>8</b> Contributions and grants (Part VIII, line 1h)		
<b>9</b> Program service revenue (Part VIII, line 2g)		
<b>10</b> Investment income (Part VIII, column (A), lines 3, 4, and 7d)		
<b>11</b> Other revenue (Part VIII, column (A), lines 5, 6d, 8c, 9c, 10c, and 11c)		
<b>12</b> Total revenue—add lines 8 through 11 (must equal Part VIII, column (A), line 12)		

Expenses	Prior Year	Current Year
<b>13</b> Grants and similar amounts paid (Part IX, column (A), lines 1–3)		
<b>14</b> Benefits paid to or for members (Part IX, column (A), line 4)		
<b>15</b> Salaries, other compensation, employee benefits (Part IX, column (A), lines 5–10)		
<b>16a</b> Professional fundraising fees (Part IX, column (A), line 11e)		
<b>b</b> Total fundraising expenses (Part IX, column (D), line 25) ▶		
<b>17</b> Other expenses (Part IX, column (A), lines 11a–11d, 11f–24e)		
<b>18</b> Total expenses. Add lines 13–17 (must equal Part IX, column (A), line 25)		
<b>19</b> Revenue less expenses. Subtract line 18 from line 12		

Net Assets or Fund Balances	Beginning of Current Year	End of Year
<b>20</b> Total assets (Part X, line 16)		
<b>21</b> Total liabilities (Part X, line 26)		
<b>22</b> Net assets or fund balances. Subtract line 21 from line 20		

**Part II Signature Block**

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than officer) is based on all information of which preparer has any knowledge.

Sign Here Signature of officer Date

Source: Internal Revenue Service Form 990. | GAO-20-454

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**Appendix II: Form 990, Return of Organization  
Exempt from Income Tax**

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The remaining pages of the Form 990 are available at IRS's website, accessed March 23, 2020: <https://www.irs.gov/pub/irs-pdf/f990.pdf>.

**Table 8: Schedules for the Form 990 and Form 990-EZ**

Schedule A	Public Charity Status and Public Support
Schedule B	Schedule of Contributors
Schedule C	Political Campaign and Lobbying Activities
Schedule D	Supplemental Financial Statements
Schedule E	Schools
Schedule F	Statement of Activities Outside the United States
Schedule G	Supplemental Information Regarding Fundraising or Gaming Activities
Schedule H	Hospitals
Schedule I	Grants and Other Assistance to Organizations, Governments and Individuals in the United States
Schedule J	Compensation Information
Schedule K	Supplemental Information on Tax-Exempt Bonds
Schedule L	Transactions with Interested Persons
Schedule M	Noncash Contributions
Schedule N	Liquidation, Termination, Dissolution, or Significant Disposition of Assets
Schedule O	Supplemental Information to Form 990 or 990-EZ
Schedule R	Related Organizations and Unrelated Partnerships

Source: Internal Revenue Service. | GAO-20-454

Note: All of the schedules may apply to Form 990 filers. Schedules A, B, C, E, G, L, N and O may apply to Form 990-EZ filers.

## Appendix III: Changes to Exempt Organization Form 990, Tax Years 2009- 2019

Most exempt organizations are required to file an annual form to report their activities, structure, revenue and expenses, and other items. The organization's classification under the Internal Revenue Code and its gross receipts and total assets, determines which form must be filed. Most organizations file one of the following:

- Form 990, *Return of Organization Exempt from Income Tax*;
- Form 990-EZ, *Short Form, Return of Organization Exempt from Income Tax*; and
- Form 990-PF, *Return of Private Foundation or Section 4947(a)(1) Trust Treated as Private Foundation*.

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### Form 990 Has Undergone Changes Since 2008 Redesign

The Internal Revenue Service (IRS) last redesigned the Form 990 series for tax year 2008. The redesign added 14 schedules to the existing two, and reflected changes in the tax-exempt sector and tax law.<sup>1</sup> Some changes from the redesign were phased in and implemented for tax year 2008 and 2009 filings. We summarized changes as found in the "What's New" section of the form instructions for each of the three Form 990 types and for each year. We grouped the changes into two categories as defined by:

- **New or revised question(s):** The addition of new lines, check boxes, narratives or schedules. This includes changes to accommodate new laws or reporting requirements, such as new reporting thresholds or standards.

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<sup>1</sup>The redesign added questions on governance, compensation, activities, relationships with related organizations, international activities, fundraising, non-cash contributions, and other compliance areas.

**Appendix III: Changes to Exempt Organization  
Form 990, Tax Years 2009- 2019**

- **Instructions and format:** New descriptions or details in the instructions, such as specifying examples or how to provide certain information to IRS. This also includes changes that affect order of lines or schedules, but not the content.

For the Form 990 changes since the redesign, IRS made 56 changes to the form or its instructions for tax years 2009 through 2019 (see table 9 below).<sup>2</sup>

**Table 9: Types of Changes to Form 990, Tax Years 2009-2019**

<b>Tax year</b>	<b>New or revised question(s) or sections on:</b>	<b>Instructions and format for:</b>
2009	<ul style="list-style-type: none"> <li>• Parts III and VI significant program services or changes (two changes).</li> <li>• Completing parts of Schedules D, L and O (three separate changes).</li> <li>• Inclusion in a consolidated, independently audited financial statement.</li> <li>• Issuance of financial statements.</li> <li>• Standard for material diversion.</li> <li>• Individuals from whom receivables should be reported.</li> <li>• Compensating leased employees.</li> <li>• Schedule H and K requirements (two changes).</li> </ul>	<ul style="list-style-type: none"> <li>• Part V, Statements Regarding Other IRS Filings and Tax Compliance.</li> <li>• New source for business activity codes.</li> <li>• Publicly traded corporate stock.</li> <li>• Reordered several lines.</li> </ul>
2010	<ul style="list-style-type: none"> <li>• Checkboxes on Schedule O responses.</li> <li>• Narratives in Schedules E, G, K, L and R.</li> <li>• Form 720 on indoor tanning services.</li> <li>• Part XI, Reconciliation of Net Assets.</li> <li>• Gross receipts and total assets thresholds.</li> <li>• Certain organizations that operate hospitals to attach financial statements.</li> <li>• Reserves at qualified nonprofit health insurance issuers.</li> <li>• Officer, director and certain employees' work at related organizations.</li> <li>• Certain miscellaneous expenses, on Schedule O.</li> <li>• Receivables from contributing employers and sponsoring organizations of 501(c)(9) organizations.</li> </ul>	<ul style="list-style-type: none"> <li>• Appendix K, Contributions.</li> <li>• Elimination of Schedules J-2, F-1, I-1, J-1, N-1 and R-1.</li> <li>• Subdivided Part VI, Section A, total line.</li> </ul>

<sup>2</sup>We did not separately analyze the Form 990 schedules.

**Appendix III: Changes to Exempt Organization  
Form 990, Tax Years 2009- 2019**

<b>Tax year</b>	<b>New or revised question(s) or sections on:</b>	<b>Instructions and format for:</b>
2011	<ul style="list-style-type: none"> <li>Decisions made by non-governing body persons.</li> <li>Schedule F foreign investment reporting threshold.</li> <li>Schedule O on disclosing governing body delegations.</li> <li>Checkbox on Part IX responses in Schedule O.</li> <li>Criteria for director independence on Schedule L.</li> <li>Business relationships of officers and others.</li> <li>501(c)(3), former highest compensated employees</li> </ul>	<ul style="list-style-type: none"> <li>Paid preparer signature block.</li> </ul>
2012	<ul style="list-style-type: none"> <li>Schedule D completion.</li> <li>Certain employees to report work hours for related organization.</li> <li>Part VIII checkbox on Schedule O responses.</li> <li>Joint venture requirements for reporting revenue and assets. (two changes).</li> <li>Schedule O—expense reporting, balance sheet reporting, and disclosure explanations (three changes).</li> <li>Part XI, Reconciliation of Assets.</li> <li>Part XII, Financial Statements and Reporting.</li> </ul>	<ul style="list-style-type: none"> <li>Public disclosure reminder.</li> <li>Example of reporting benefits from self-insured medical reimbursement plan.</li> </ul>
2013	<ul style="list-style-type: none"> <li>Form 990-N filers reporting changes to accounting period.</li> </ul>	
2014		<ul style="list-style-type: none"> <li>Part XI, Reconciliation of Assets.</li> <li>Group returns with a supporting organization.</li> </ul>
2018	<ul style="list-style-type: none"> <li>Excise tax on net investment income of certain colleges and universities.</li> <li>Excise tax on executive compensation.</li> <li>Unrelated business taxable income</li> <li>Certain organizations no longer required to report certain contributor details on Schedule B.</li> </ul>	

Source: GAO analysis of Form 990 instructions. | GAO-20-454

These changes include three to the 2018 form implementing new excise taxes on net investment income of certain colleges and universities and on certain tax-exempt organization executive compensation.<sup>3</sup> Aside from new electronic filing requirements for tax years beginning July 2, 2019, the 2019 form did not have any changes.<sup>4</sup> In addition to the 56 changes, IRS made 95 clarifications to existing lines or instructions, or revisions to definitions from tax years 2009 through 2018. These clarifications provide more specific definitions or other details.

<sup>3</sup>26 U.S.C. §§ 4968, 4960.

<sup>4</sup>Pub. L. No. 116-25, § 3101, 133 Stat. 981, 1015–1016 (2019), *codified at* 26 U.S.C. §§ 6011(h), 6033(n).

**Appendix III: Changes to Exempt Organization  
Form 990, Tax Years 2009- 2019**

Further, several of the schedules had additions. For example, the Patient Protection and Affordable Care Act led to additional reporting on Schedule H, *Hospitals*, to fulfill requirements that hospitals report on each of their facilities and conduct a Community Health Needs Assessment every 3 years.<sup>5</sup>

Most of the Form 990-EZ’s 27 changes occurred in tax years 2009 through 2012, of which 12 were for 2011 and several of them focused on compensation reporting. IRS also made 27 clarifications for 2009-2013. Public Law 115-97 did not affect Form 990-EZ. <sup>6</sup> There were no changes to the 2019 form.<sup>7</sup> See table 10.

**Table 10: Types of Changes to Form 990-EZ, Tax Years 2009-2019**

<b>Tax year</b>	<b>New or revised question(s) or sections on:</b>	<b>Instructions and format for:</b>
2009	<ul style="list-style-type: none"> <li>Gross receipts and total assets thresholds</li> </ul>	<ul style="list-style-type: none"> <li>Moved Schedule A filing instructions</li> </ul>
2010	<ul style="list-style-type: none"> <li>Narratives and other responses on Schedule O</li> <li>Income from fundraising events and gaming.</li> <li>Political campaign activities for all filers.</li> <li>Gross receipts and total assets thresholds</li> <li>Form 990-N filing option for some organizations.</li> </ul>	
2011	<ul style="list-style-type: none"> <li>Eliminated reporting addresses for certain employees or trustees.</li> <li>Reportable compensation—where to report and method (two changes).</li> <li>Health benefits.</li> <li>Compensation estimates and exclusions.</li> <li>Form 990-T reporting.</li> <li>Part IV, line 50 columns.</li> </ul>	<ul style="list-style-type: none"> <li>Definition of “year” for reporting employee compensation.</li> <li>Definition of “year” for reporting contractor compensation.</li> <li>Examples of insignificant dispositions of net assets.</li> <li>Paid preparer signature block.</li> <li>Appendix H, Contributions.</li> </ul>
2012	<ul style="list-style-type: none"> <li>Schedule K-1 requirements.</li> <li>Part IV columns.</li> <li>Part VI columns.</li> </ul>	<ul style="list-style-type: none"> <li>Public disclosure reminder.</li> </ul>
2013	<ul style="list-style-type: none"> <li>Item K checkbox for organization form.</li> <li>Form 990-N filers, accounting period changes.</li> </ul>	
2014	<ul style="list-style-type: none"> <li>Item B checkbox for terminated organizations.</li> </ul>	

<sup>5</sup>26 U.S.C. § 501(r).

<sup>6</sup>Pub. L. No. 115-97, 131 Stat. 2054 (2017), commonly known as the Tax Cuts and Jobs Act.

<sup>7</sup>Transition relief from electronic filing requirements in section 3101 of Public Law 116-25 applies to Form 990-EZ filers for returns filed for any tax year before July 2, 2020.

**Appendix III: Changes to Exempt Organization  
Form 990, Tax Years 2009- 2019**

<b>Tax year</b>	<b>New or revised question(s) or sections on:</b>	<b>Instructions and format for:</b>
2018	<ul style="list-style-type: none"> <li>Certain organizations no longer required to report certain contributor details on Schedule B.</li> </ul>	

Source: GAO analysis of Form 990-EZ instructions. | GAO-20-454

For the Form 990-PF, IRS made the fewest changes compared to Forms 990 and 990-EZ, with only 11 changes and four clarifications for tax years 2009 through 2019. The Form 990-PF had three changes prompted in 2018 by Public Law 115-97. Electronic filing requirements apply to Form 990-PF for tax years starting July 2, 2019, but there were no other changes for the 2019 form. See table 11.

**Table 11: Types of Changes to Form 990-PF, Tax Years 2009-2019**

<b>Tax year</b>	<b>New or revised question(s)</b>	<b>Instructions and format</b>
2013	<ul style="list-style-type: none"> <li>New attachments on excess business holdings.</li> </ul>	<ul style="list-style-type: none"> <li>Part B, What Parts to Complete.</li> <li>Parts U and V, section 507(b)(1)(B) terminations.</li> <li>Former publicly supported organization filing as private foundation.</li> </ul>
2014	<ul style="list-style-type: none"> <li>Grants to supporting organizations and exempt operating foundations.</li> </ul>	
2015	<ul style="list-style-type: none"> <li>Dues exemption for agricultural and horticultural organizations.</li> </ul>	
2018	<ul style="list-style-type: none"> <li>Excise tax on excess business holdings.</li> <li>Excise tax on executive compensation.</li> <li>Global intangible low-taxed income.</li> <li>Section 965(a) income.</li> <li>Increase in unrelated business taxable income by disallowed.</li> </ul>	

Source: GAO analysis of Form 990-PF instructions. | GAO-20-454

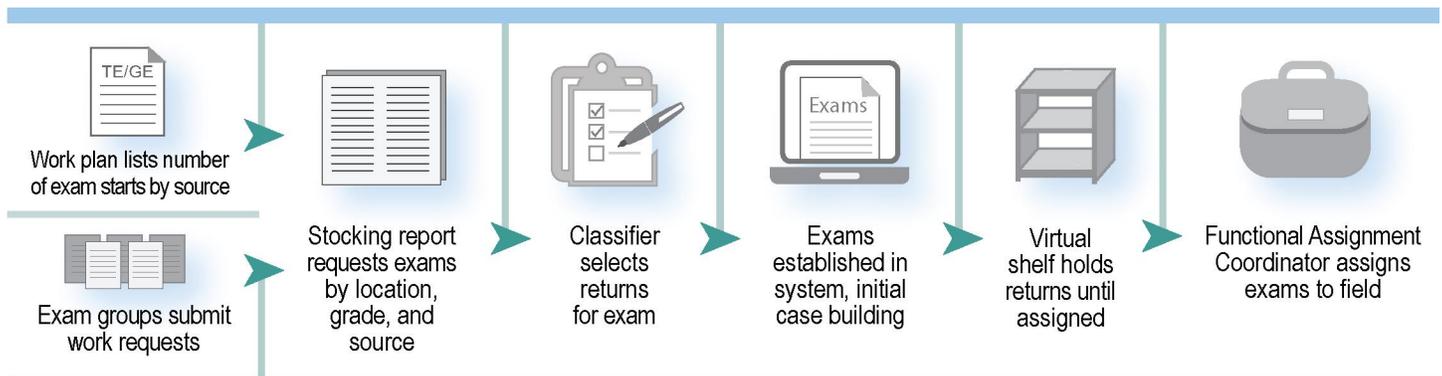
# Appendix IV: Exempt Organizations Examination Selection Process

Appendix IV describes the general examination selection process for exempt organization returns, and specific classification steps that apply to certain returns.

## General Selection Process for Exempt Organizations Examinations

The annual work plan is the foundation for identifying and assigning returns for examination. The Compliance Planning and Classification (CP&C) office follows various steps to identify returns to fulfill the work plan, which end in the assignment of returns for potential examinations to field work groups. The intended process is in figure 11 and discussed below.

Figure 11: General Selection Process for Exempt Organizations Examinations



Source: GAO analysis of Internal Revenue Service (IRS) information. | GAO-20-454

- **Annual work plan.** CP&C's Planning and Monitoring group develops the annual work plan. The work plan provides estimates of

examination starts and closures.<sup>1</sup> It also has estimates for the number of hours to be spent per return examination and the number of days to complete an examination. Planning and Monitoring develops estimates at the project code level, which corresponds to a specific examination source or project such as the Form 990 model. The Tax Exempt and Government Entities' (TE/GE) Compliance Governance Board approves the work plan. TE/GE provides a summary of the work plan in its annual Program Letter.<sup>2</sup>

- **Stocking report.** The Planning and Monitoring group uses the work plan to issue “stocking” reports to guide classifiers on types of returns to identify for potential examination. Planning and Monitoring considers available examiners, and progress in meeting work plan numbers. The report lists the number of returns needed by grade, project code, and classification source.<sup>3</sup>
- **Classification.** Classifiers review stocking plans to identify returns for potential examination. Classifiers are to eliminate returns for consideration if the (1) return is approaching its statute of limitation date, (2) organization has been examined in the last 3 years, or (3) organization is under a compliance check.<sup>4</sup>
- **Establishing the return and initial case building.** If classifiers identify examination potential, they establish returns in the Audit Information Management System and Reporting Compliance Case Management System (RCCMS).<sup>5</sup> The returns are sent for initial case building—developing paperwork to initiate the examination—according to a TE/GE official.
- **Virtual shelf.** Established returns and the initial case material are sent to the virtual shelf, which is an electronic inventory of returns that may be assigned for examination. Certain referrals, claims,

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<sup>1</sup>Although the work plan also includes estimates for compliance checks, our analysis focuses on examinations.

<sup>2</sup>The Program Letter describes compliance priorities and plans for each fiscal year.

<sup>3</sup>Examinations are graded based on their complexity and the type of organization involved, and must be assigned according to an examiner's grade level.

<sup>4</sup>Statute of limitation dates are based on the filing due date of the return. In general, IRS has 3 years from the due date or filing date, whichever is later, to close an examination. 26 U.S.C. § 6501(a). Compliance checks determine whether reporting and filing requirements have been met, or to determine whether an organization's activities are consistent with its stated tax-exempt purpose.

<sup>5</sup>RCCMS provides inventory management and case management and is a management and monitoring tool for TE/GE enforcement activities.

compliance strategies, and other returns are prioritized, according to a TE/GE official. Returns remain on the shelf until assigned for examination or otherwise closed due to statute of limitations, according to a TE/GE official.

- **Examination assignment.** Functional Assignment Coordinators pull returns from the virtual shelf to fulfill field group work requests. Returns on the virtual shelf that matched a work order undergo additional case building before delivery to field examination groups.
- **Monitoring.** Planning and Monitoring staff regularly review reports that compare work plan goals with current work, and run algorithms to forecast upcoming work. These reviews are intended to ensure that sufficient work is available for assignment, excess work is not created, and returns approaching statute of limitations are identified. The monitoring informs new stocking reports.

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## Specific Classification Steps for Models and Certain Other Examination Sources

Classification steps vary depending on how a return was identified for potential examination. For returns identified with queries or models, classifiers check a limited set of criteria once a return is identified. For returns identified through other sources, such as referrals, the classifier also reviews facts and circumstances about potential noncompliance in returns. We focus here on examination sources that rely on data—such as models or queries—and referrals. Referrals are complaints of exempt organization noncompliance made by third parties, including the public and other parts of the Internal Revenue Service. We describe referrals classification because it is one of the top sources of exempt organizations examinations.

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### Analytical Models

The models are run to identify returns with potential noncompliance and lists them on a Model Score Sheet (MSS). The MSS is a ranked list of returns by scores from the model. According to a TE/GE official, the classifier:

- works down the list, starting with the highest scores, to fill stocking reports;

- checks whether the return was also identified for a compliance strategy; and.<sup>6</sup>
- eliminates returns based on the statute of limitations and recent examination activity.<sup>7</sup>

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## Compliance Strategies

For some projects in the Compliance Strategies portfolio, a query is run or returns are sampled to identify a population meeting indicators of potential noncompliance. Then, the classifier uses the stocking report to select returns with certain geographic or case grade criteria and eliminates returns based on statute of limitations, recent examination status, and resolving non-filing issues, according to a TE/GE official.

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## Referrals

TE/GE classifiers do a triage to review and eliminate referrals that are not relevant to tax administration or do not have substantiated information. The triage classifier sorts referrals and reviews the following:

- statute of limitations;
- organization status (for example, already revoked or terminated);
- examination history of the organization; and
- evidence of substantial inurement or private benefit, non-exempt activities, or material employment tax or unrelated business income that would result in a significant tax assessment.

Referrals that pass triage are either sent to classification or, if they deal with political issues, are sent to a committee of three TE/GE managers, who vote on a selection decision.<sup>8</sup> For all referrals, the classifier

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<sup>6</sup>If so, the return will be examined under the compliance strategy, according to a TE/GE official. A compliance strategy is a priority or emerging issue for exempt organization compliance that went through a specific approval process. Examinations or compliance contacts may be conducted based on the strategies.

<sup>7</sup>As time passes since the models' runs, the classifier must review whether statute of limitations dates are approaching.

<sup>8</sup>The Political Activities Referral Committee is composed of three members selected at random from a pool of exempt organizations managers. The committee is responsible for considering the audit potential of referrals with evidence of impermissible political or lobbying activity.

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**Appendix IV: Exempt Organizations  
Examination Selection Process**

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researches the referral. Research sources include websites, external databases, and IRS taxpayer account databases. The classifier may look at the organization's website, information about officers, or prior examination history.

Referrals with examination potential are either assigned immediately or placed on the virtual shelf. Referrals that must be immediately assigned include those with strong indicators of fraud, illegal or illicit activities (including terrorism), or referrals from whistleblowers, or certain other IRS divisions. Other referrals are labeled as high, medium or lower priority, based on potential for revocation or significant tax assessments.

# Appendix V: Status of Contractor Recommendations on Exempt Organizations Examination Selection

The Tax Exempt and Government Entities division (TE/GE) hired a contractor to review the effectiveness of its Form 990 examination selection model. The contractor prepared two reports. The first, delivered in January 2018, makes recommendations on the model process, the computing environment, and performance measures. The second, delivered in July 2018, makes recommendations to more effectively and efficiently identify returns for examination, such as through the model. Within the two reports, the contractor made 17 recommendations. Table 12 lists the recommendations and the status of each.

**Table 12: Contractor Recommendations and Their Status (as of March 2020)**

Contractor Recommendation	Status
1. Define which examination outcomes represent the “next best case” and conduct evaluations using them.	Not implemented. TE/GE officials said they are exploring measures and metrics and the contractor’s 2020 report is to cover this issue.
2. Compare model missing schedule queries to IRS’s criteria for rejecting incomplete returns. <sup>a</sup>	Not implemented. TE/GE officials said they are considering a broader strategy of using reject rules for exempt organizations and the contractor’s 2020 report is to cover this issue.
3. Eliminate or combine redundant queries.	Not implemented. The contractor’s 2020 report is to cover this issue, according to TE/GE officials.
4. Review the query principal issue code suggestions to align with query compliance issues. <sup>b</sup>	Not implemented. All examination selection strategies are being evaluated and will require subject matter experts, according to TE/GE officials.
5. Evaluate restructuring the model and queries to be based on the resource (examination, letter and other contacts) needed to address a compliance issue.	Not implemented. The contractor’s 2020 report is to cover this issue, according to TE/GE officials.
6. Develop an alternative approach to address international issues.	Not implemented. Queries on international issues will be evaluated as resources permit, according to TE/GE officials, and subject matter experts will be needed.
7. Continue to monitor individual query performance and obtain sufficient examination results to evaluate query performance.	Not implemented. TE/GE officials said they are exploring measures and metrics using available data as appropriate.

**Appendix V: Status of Contractor  
Recommendations on Exempt Organizations  
Examination Selection**

Contractor Recommendation	Status
8. Conduct rigorous historical analysis of queries.	Not implemented. The contractor's 2020 report is to cover this issue, according to TE/GE officials.
9. Track the number of returns selected, examined and not-examined for each query.	Not implemented. The contractor's 2020 report is to cover this issue, according to TE/GE officials.
10. Consider whether to require that ideas for major model updates be submitted through TE/GE online issue submission portal.	Implemented. Any future model updates will be presented to the TE/GE Compliance Governance Board (Governance Board) for approval, according to TE/GE officials. Our analysis showed evidence of Governance Board review of new queries.
11. The Compliance Planning and Classification Director should review model changes that impact which returns receive a score, and require that such changes are highlighted in materials that the Governance Board reviews prior to approving model changes.	Not Implemented. TE/GE officials said no new queries have been approved since this recommendation was made.
12. Store model documentation, including programming code, scores for each return and query hit information.	Not implemented. TE/GE has not identified a long-term solution for storing model data. For the 2020 study task order, storage space for model data is available. The contractor's 2020 report is to cover this issue, according to TE/GE officials.
13. Use weighted disposal score to determine model effectiveness. <sup>c</sup>	Not implemented. TE/GE officials said they have not analyzed weighted disposal scores because of concerns over their inconsistencies. These data are available for the contractor to use in its 2020 study, according to TE/GE officials.
14. Implement automated downloads of model performance metrics.	Not implemented. TE/GE is exploring alternative approaches to performance reporting and the contractor's 2020 report is to cover this issue, according to TE/GE officials.
15. Consider using dashboards or other tools to communicate performance data visually.	TE/GE has not provided a status for this recommendation.
16. Develop and adopt a measure to relate model scores to examination results.	Not implemented. TE/GE officials said they are considering how to best evaluate examination selection methods and the contractor's 2020 report is to cover this issue.
17. Identify TE/GE staff and assess training or hiring needs for data science skills, such as programming and analysis.	Implemented part of the recommendation on hiring needs. A TE/GE official said TE/GE worked with other IRS groups to identify the desired skills for a data scientist, but it does not have hiring authority. It did not provide evidence of assessing training needs.

Source: GAO analysis. | GAO-20-454

Notes:

<sup>a</sup>Returns are sent back to the exempt organization during processing if certain schedules are missing.

<sup>b</sup>A principal issue code identifies compliance issues found during an examination.

<sup>c</sup>When an examination is closed, an examiner assigns a disposal code which indicates the action taken. TE/GE assigned weights to rank the severity of the disposal codes, on a scale of one (the least severe) to 10 (the most).

In September 2019, TE/GE initiated another study, anticipated to be completed in September 2020. The study focuses on developing alternatives to enhance the models. The study will explore architectures and alternative designs for the model and propose alternative compliance actions to examinations and recommend measures to monitor their effectiveness.

# Appendix VI: Comments from Internal Revenue Service



DEPUTY COMMISSIONER

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, DC 20224

May 22, 2020

James R. McTigue Jr.  
Director, Tax Issues/Strategic Issues  
United States Government Accountability Office  
441 G Street, NW  
Washington, DC 20548

Dear Mr. McTigue:

Thank you for the opportunity to review the draft report of the Government Accountability Office GAO-20-454 entitled "***Tax Exempt Organizations: IRS Increasingly Uses Data in Examination Selection but Could Further Improve Selection Processes (job code 103138)***". We appreciate the analysis in the report and, as you noted in your report, we have ongoing efforts underway. Your recommendations will drive our continued efforts.

During the period under review, the Internal Revenue Service (IRS) reorganized the relevant operation. For efficiency and objectivity, the Tax-Exempt/Government Entities (TE/GE) operating division centralized the caseload selection that had been embedded among five disciplines, including Exempt Organizations (EO). Initiating collaboration with the IRS Research, Applied Analytics & Statistics (RAAS) office, TE/GE elevated data analytics as a centerpiece of the new Compliance Planning & Classification (CP&C) function. Until then, analytics had been a legacy project loosely known as the Form 990 case selection "model".

As documented throughout the reorganization, the continuing formalization of data analytics addresses the risk remaining from the informality of the predecessor model, which is maturing into a rigorous compliance query set. Furthermore, CP&C is extending data analytics to the other disciplines to ensure a uniform approach across TE/GE. With the assistance of internal and external consultants, CP&C introduced the compliance issue submission portal for TE/GE employee crowd-sourcing and systemic documentation of strategies based on tax requirements. Meanwhile, CP&C has centralized the traditional referral process to classify incoming complaints about perceived tax violations. While referrals are inherently qualitative, CP&C makes the classification more objective by distancing it from the exam functions that would have to pursue the allegation. Due to the magnitude of the transformation involving more than a hundred employees and thousands of cases, no single document may encompass every detail. Nonetheless, CP&C was the highly intentional result of input across the IRS.

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**Appendix VI: Comments from Internal Revenue Service**

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We appreciate having had the opportunity to review and comment on the draft report. Responses to your specific recommendations are enclosed. If you have questions, please contact me, or a member of your staff may contact Sean E. O'Reilly, Director, Compliance Planning and Classification at 718-834-5061.

Sincerely,

**Sunita B. Lough**

Digitally signed by Sunita B. Lough  
Date: 2020.05.22 09:51:47 -0400

Sunita Lough  
Deputy Commissioner for Services and Enforcement

Enclosure

Enclosure

**GAO Recommendations and IRS Responses to GAO Draft Report  
GAO-20-454, Tax Exempt Organizations: IRS Increasingly Uses Data in  
Examination Selection, but Could Further Improve Selection Processes  
(job code 103138)**

**Recommendation 1:**

The Commissioner of Internal Revenue should document measurable objectives for using data in selecting exempt organization returns for examination.

**Comment:**

The IRS agrees with the recommendation. TE/GE will document objectives for using data to make decisions on which returns to select for examination.

**Recommendation 2:**

The Commissioner of Internal Revenue should document and consistently use clear criteria and decision rules on assigning point values to queries, using categories and sliding scales.

**Comment:**

The IRS agrees with the recommendation. TE/GE will document criteria and decision rules on assigning values in the compliance query sets. The documentation will be applied to future query sets.

**Recommendation 3:**

The Commissioner of Internal Revenue should require a regular review of query descriptions and programming to ensure their accuracy and minimize queries that flag the same or similar compliance issue.

**Comment:**

The IRS agrees with the recommendation. TE/GE will review and adjust query descriptions and programming as necessary and appropriate, and document the adjustments. TE/GE will establish a process to conduct a regular review of compliance query sets.

**Recommendation 4:**

The Commissioner of Internal Revenue should develop procedures and criteria to test new queries prior to implementation in the models.

**Comment:**

The IRS agrees with the recommendation. TE/GE will document procedures and criteria to test new queries prior to implementation in the compliance query sets.

**Recommendation 5:**

The Commissioner of Internal Revenue should more fully document how it processes data and uses data to make examination selection decisions for sources outside of the model such as research projects and other projects that use queries.

**Comment:**

The IRS agrees with the recommendation. CP&C will provide GAO documentation for a project (other than compliance strategies) that is approved through the governance board.

**Recommendation 6:**

The Commissioner of Internal Revenue should conduct an analysis to identify the optimal interval between model runs.

**Comment:**

The IRS agrees with the recommendation. TE/GE will conduct an analysis of the return due date of the filing populations most commonly associated with an EO examination.

**Recommendation 7:**

The Commissioner of Internal Revenue should establish a process for regularly evaluating selection decisions and related outcomes for the models and other processes that use data to select returns for examinations.

**Comment:**

The IRS agrees with the recommendation. TE/GE will establish and document a process to evaluate selection decisions and other outcomes for queries and processes that use data to select returns for examinations.

**Recommendation 8:**

The Commissioner of Internal Revenue should document consideration or action on recommendations from its 2018 and 2020 contractor assessments of TE/GE examination selection.

**Comment:**

The IRS agrees with the recommendation. TE/GE will document actions from the 2018 and 2020 contractor assessments.

**Recommendation 9:**

The Commissioner of Internal Revenue should document how score and query data for all returns in the model will continue to be saved over the long term.

**Comment:**

The IRS agrees with the recommendation. TE/GE will document the steps associated with scoring, storage, and record retention of the compliance query set data.

**Recommendation 10:**

The Commissioner of Internal Revenue should ensure that historical data on examination outcomes are consistently defined.

**Comment:**

The IRS disagrees with the recommendation. TE/GE maintains historical examination outcomes data within systems of record such as AIMS and RCCMS that are consistently defined within each system, and TE/GE's source data has not changed.

**Recommendation 11:**

The Commissioner of Internal Revenue should routinely analyze the reasons for not examining selected returns and identify any necessary actions to address the reasons.

**Comment:**

The IRS agrees with the recommendation. TE/GE will analyze the reasons for not examining selected returns and identify any necessary actions to address the reasons.

**Recommendation 12:**

The Commissioner of Internal Revenue should annually review and update procedures as needed in relevant IRM sections on examination selection and issue interim guidance until the affected IRM sections are updated.

**Comment:**

The IRS agrees with the recommendation. TE/GE will review and update procedures as needed in relevant IRM sections on examination selection and issue interim guidance until the affected IRM sections are updated.

**Recommendation 13:**

The Commissioner of Internal Revenue should document why TE/GE has not identified any risks in its risk register for using data to select exempt organization returns for examination. If risks are subsequently identified, TE/GE should document how it plans to analyze and address them.

**Comment:**

The IRS agrees with the recommendation. TE/GE will document why TE/GE had not previously identified risks in its risk register for using data at the functional level to select exempt organization returns for examination. As risks are subsequently identified, TE/GE will document how it plans to analyze and address them.

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## Agency Comment Letter

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### Text of Appendix VI: Comments from Internal Revenue Service

#### Page 1

May 22, 2020

James R. McTigue Jr.  
Director, Tax Issues/Strategic Issues  
United States Government Accountability Office  
441 G Street, NW  
Washington, DC 20548

Dear Mr. McTigue:

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# Appendix VII: GAO Contact and Staff Acknowledgments

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## GAO Contact

James R McTigue, Jr. (202) 512-9110 or [mctiguej@gao.gov](mailto:mctiguej@gao.gov)

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## Staff Acknowledgments

In addition to the contact named above, Tom Short (Assistant Director), Lindsay Swenson (Analyst-in-Charge), Ann Czapiewski, George Guttman, Amalia Konstas, Krista Loose, Alan Rozzi, Cynthia Saunders, Andrew J. Stephens, and Sonya Vartivarian made key contributions to this report.

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