

GAO

Testimony

Before the House Committee on Ways and Means

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## TAX-EXEMPT SECTOR

# Governance, Transparency, and Oversight Are Critical for Maintaining Public Trust

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Highlights of [GAO-05-561T](#), a testimony before the House Committee on Ways and Means

### Why GAO Did This Study

The tax-exempt sector under section 501(c) of the Internal Revenue Code covers over a million-and-a-half entities of varying sizes and purposes. Its diversity allows it to address the needs of many citizens. To help it do so, Congress and some in the tax-exempt sector itself encourage good governance practices by exempt entities. Transparency over exempt entities' activities is aided by public access to their annual tax returns. As the nation's tax administrator, the Internal Revenue Service (IRS) has a key role in overseeing this sector. Oversight can help ensure adherence to exempt purposes, protect against abuses, and sustain public support for the sector.

The Chairman of the House Committee on Ways and Means asked GAO to address (1) the growth of the section 501(c) tax-exempt sector; (2) the role of governance and transparency in ensuring that tax-exempt entities function effectively and with integrity; (3) IRS's capacity for overseeing the exempt sector, including its results and efforts to address critical compliance problems; and (4) states' oversight and their relationship with IRS in overseeing the tax-exempt sector.

### What GAO Recommends

GAO makes no recommendations but suggests a full re-examination of the tax-exempt sector in light of the challenges facing the nation in the 21<sup>st</sup> century.

[www.gao.gov/cgi-bin/getrpt?GAO-05-561T](http://www.gao.gov/cgi-bin/getrpt?GAO-05-561T). To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or [brostekm@gao.gov](mailto:brostekm@gao.gov).

## TAX-EXEMPT SECTOR

# Governance, Transparency, and Oversight Are Critical for Maintaining Public Trust

### What GAO Found

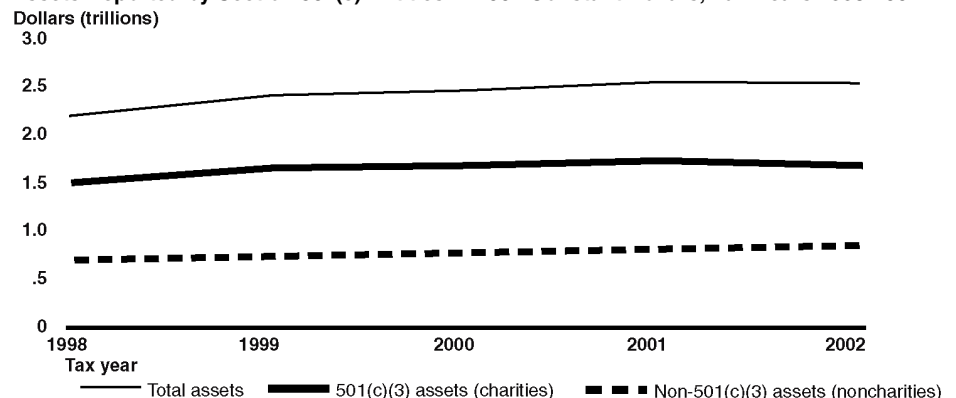
The section 501(c) tax-exempt sector has grown steadily in reported assets, revenues, and expenses. For example, between 1998 and 2002 (the most recent year of data), its reported assets grew to over \$2.5 trillion—with 12 percent growth for 501(c) charities and 22 percent growth for other 501(c) entities (noncharities). Accordingly, this tax-exempt sector comprises a significant part of the nation's economy and workforce. For example, spending in this sector appears to be about one-tenth of our economy and the paid exempt workforce appears to be comparable in size to some of the largest sectors of the U.S. civilian workforce, such as food and lodging.

Good governance and transparency are essential elements to help provide assurance that exempt entities operate with integrity and effectiveness in meeting their missions. Good governance facilitates well-run operations that dissuade abusive behavior. Transparency sheds light on entities' practices, which enhances ethical and effective operations and facilitates oversight by the public and others. With recent concerns about abuses in the tax-exempt sector, renewed attention is being given to improving governance practices and increasing the transparency related to the sector.

Staffing trends and insufficient data have contributed to IRS being challenged in executing its oversight role. IRS has begun to increase staffing, obtain better data on tax-exempt entities, and increase its capacity to analyze and use the data it obtains. For the critical compliance issues IRS has identified, it has started special initiatives to improve compliance.

States often oversee tax-exempt entities, frequently focusing on protecting the public from fraudulent activities and guarding against misuse of charitable assets. States and the IRS believe that more data sharing would make their oversight more efficient and effective. Consistent with our earlier recommendations, IRS has improved its processes for sharing its oversight data with the states, and Congress is considering expanded data sharing.

**Assets Reported by Section 501(c) Entities in 2004 Constant Dollars, Tax Years 1998-2002**



Source: Tabulation of data from IRS's Return Inventory Classification System, 1998-2002.

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Chairman Thomas and Members of the Committee:

I am pleased to participate in today's hearing about the tax-exempt sector and oversight of it. The sector recognized under section 501(c) of the Internal Revenue Code (IRC) covers a diverse group of over 1.5 million entities with varying sizes and exempt purposes (see app. I for types of section 501(c) exempt entities). The breadth and diversity of the tax-exempt sector allows it to address the specific needs of many of our citizens and the general needs of society. The exempt sector, and those who volunteer to assist, also supplements government programs to meet various needs. For example, charities can supplement programs by providing comfort to the aging, health care to the uninsured, and education to the uneducated.

As the nation's tax administrator, the Internal Revenue Service (IRS) has a key role in overseeing the tax-exempt sector. Oversight can help sustain public faith in the sector and ensure that exempt entities stay true to the purposes that justify their tax exemption. It also can help protect the entire sector from potential abuses initiated by a small minority.

Before discussing the work we did for the Committee, I want to frame today's hearing within a broader context. GAO recently issued a report entitled, *21<sup>st</sup> Century Challenges: Reexamining the Base of the Federal Government*.<sup>1</sup> This report provides examples of a number of key questions that need to be explored in light of our current and projected fiscal imbalances as well as other changes and challenges. It highlights the need for a re-examination of all major federal policies and programs in light of 21<sup>st</sup> century realities. Although that report did not specifically cover the tax-exempt sector, the sector is a microcosm of the issues raised in the report. While the provisions granting federally recognized tax-exempt status and associated policies have been layered upon one another to respond to challenges at the time, a comprehensive re-examination of the tax-exempt sector has not been done in recent times. On a broad scale, a comprehensive re-examination could help address whether exempt entities are providing services to our citizens commensurate with their favored tax status, whether the current number and nature of exemptions continue to make sense, whether restrictions on the activities of tax-exempt entities remain relevant, and whether the framework for ensuring that exempt entities adhere to the requirements attendant to their status is satisfactory.

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<sup>1</sup> [GAO-05-325SP](#).

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Today's hearing provides an excellent forum to launch such a re-examination. Some of the more specific issues that may merit re-examination for the tax-exempt sector include:

- Should the criteria for granting exempt status be reconsidered and do we need as many types of tax-exempt entities?
- Do we need to modify the model used in overseeing tax-exempt entities to ensure that the tax-exempt purpose is met and that fraud or other misuse is deterred?
- What governance standards should apply to the tax-exempt sector, and should particular types of exempt entities have more specific standards?
- Are the operations and activities of tax-exempt organizations sufficiently transparent to support oversight by the public, news media, and federal, state, and local governmental agencies?
- Beyond revoking tax-exempt status and various currently available intermediate sanctions, do we need more intermediate sanctions to deter abuse and enhance accountability while minimizing any damage to those served by the exempt entity?
- Should certain federal audit and internal control requirements apply to tax-exempt entities, and if so, how should the requirements vary according to entities' size or other characteristics?
- Is there sufficient transparency over the total compensation package and its justification for executives and other officials at tax-exempt entities?
- What should be the allowable "lobbying and political" activities in which different types of tax-exempt entities can engage and how should such activities be reported?
- What are the differences between nonprofit and for-profit entities that perform similar missions, such as nonprofit and for-profit hospitals, and do the nonprofit entities provide sufficiently different services to justify their exemption?

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Based on your request, I will discuss

- the growth of the tax-exempt sector, focusing on those entities whose tax-exempt status falls under section 501(c) of the IRC;
- the roles of sound governance practices and transparency in ensuring that tax-exempt entities function with integrity and perform their missions effectively;
- IRS's capacity for overseeing those exempt from taxation under section 501(c), results of its oversight activities, and efforts to address critical compliance problems; and
- the states' role in overseeing tax-exempt entities and their relationship with IRS in conducting oversight.

To summarize the growth of the tax-exempt sector, we analyzed data filed annually with IRS by section 501(c) entities. To summarize governance practices and transparency in the tax-exempt sector, we reviewed documents published by IRS and others, and official statements made in testimony before Congress. To summarize IRS's oversight capacity, results, and efforts to deal with critical compliance problems, we reviewed IRS's data and interviewed IRS officials. To summarize the role of states and their relationship with IRS, we reviewed our previous reports<sup>2</sup> and outside articles and reports. To the extent possible, we sought data from 1998 through the most recent year available for all descriptive statistics. We reviewed the reliability of the data used and found them reliable for our purposes. We did our work from December 2004 through March 2005 in accordance with generally accepted government auditing standards.

Let me begin by highlighting key points I will make.

- The 501(c) tax-exempt sector has grown steadily in reported assets, revenues, and expenses. For example, between 1998 and 2002 (the most recent year of available data), their reported assets grew 15 percent to over \$2.5 trillion. Accordingly, the tax-exempt sector comprises a

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<sup>2</sup> See *Tax-Exempt Organizations: Improvements Possible in Public, IRS, and State Oversight of Charities*, [GAO-02-526](#) (Apr. 30, 2002); *Political Organizations: Data Disclosure and IRS's Oversight of Organizations Should Be Improved*, [GAO-02-444](#) (July 17, 2002); and *Vehicle Donations: Benefits to Charities and Donors, but Limited Program Oversight*, [GAO-04-73](#) (Nov. 14, 2003).

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significant part of the nation's economy and workforce. For example, spending in the tax-exempt sector appears to be about one-tenth of our economy and the paid exempt workforce appears to be comparable in size to some of the largest sectors of the U.S. civilian workforce, such as food and lodging. The sector's significance in the economy might be greater because the asset, revenue, and expense data are likely understated to some unknown amount. For example, the data do not include all tax-exempt entities under section 501(c) because not all entities are required to file, such as religious entities, and some entities do not file required Form 990.

- Good governance and transparency are essential elements to ensure that tax-exempt entities operate with integrity and effectiveness in carrying out their missions. Governance facilitates well-run operations that dissuade abusive behavior. Transparency sheds light on entities' practices, which enhances incentives for ethical, efficient, and effective operations and facilitates oversight by the public and others. With recent concerns about abuses within the tax-exempt sector, renewed attention is being given to improving governance practices and expanding and increasing the transparency of the sector's operations.
- Staffing trends and insufficient data have contributed to IRS being challenged in executing its oversight role. IRS has begun to increase staffing during 2005, which results in 467 full-time equivalents (FTE) to examine the compliance of about a half million section 501(c) entities that file Forms 990. However, IRS does not know the extent to which these entities comply. Recognizing this, IRS started efforts in 2002 to obtain compliance data for various segments of the exempt sector but had to suspend most of these efforts to use those resources on higher priorities such as pursuing known types of noncompliance. For example, IRS has ongoing special compliance initiatives dealing with critical issues such as excessive compensation and abusive tax transactions involving exempt entities. IRS is also seeking ways to access and better analyze existing data at IRS or elsewhere on exempt entities.
- States often oversee tax-exempt entities, frequently focusing on protecting the public from fraudulent activities and guarding against misuse of charitable assets. States and IRS believe that more data sharing would make their oversight more efficient and effective. Consistent with our earlier recommendations, IRS has improved its processes for sharing data and Congress has been considering a

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legislative proposal to expanded IRS's authority to share data with specified state officials under appropriate restrictions and protections related to using the data.

My statement today will address each of these topics in turn. Before that, I will provide some background on the tax-exempt sector and IRS's oversight of it.

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## Background

Internal Revenue Code (IRC) section 501(c) specifies 28 types of entities that are eligible for tax-exempt status and over 1.5 million entities have been recognized as exempt as of 2003.<sup>3</sup> Section 501(c) entities are involved in a variety of activities and exempt purposes. Congress authorized the tax exemption for each type of entity to meet specific purposes, such as health care for the uninsured.

Almost two-thirds of these entities--over 960,000 in 2003--were classified as 501(c)(3) charities, which have exempt purposes such as serving the poor; advancing religious, educational, and scientific endeavors; protecting human rights; and addressing various other social problems.<sup>4</sup> About another 20 percent of exempt entities were social welfare organizations, labor unions, and business associations--501(c) (4 through 6), respectively. The remainder covered an array of types of exempt entities with varying purposes and numbers. In 2003, such types included 15 teacher retirement funds, over 10,000 cemetery companies, over 4,000 state-chartered credit unions, an employee-funded pension trust, 20 corporations to finance crop operations, and over 35,000 veteran organizations.

An entity that believes it meets the requirements set by Congress must apply to IRS to obtain tax-exempt recognition by submitting the following:<sup>5</sup>

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<sup>3</sup> Other types of tax-exempt entities are authorized under other Section 501 subsections such as for cooperative hospital service or educational investment organizations or under other sections such as Section 521 (farmer cooperatives) and Section 527 (political organizations), among others.

<sup>4</sup> Taxpayers may deduct from their taxable income the value of donations to charities, unlike for almost all other types of tax-exempt entities.

<sup>5</sup> Entities that are not required to apply include those that are not private foundations and that have gross receipts of less than \$5,000 as well as churches and church-affiliated entities.

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- Form 1023 (Application for Recognition of Exemption under Section 501(c) (3) of the Internal Revenue Code) or Form 1024 (Application for Recognition of Exemption under 501(a));
  - organizing documents, such as the Articles of Incorporation, Articles of Association, Trust Indenture, Constitution, or other enabling documents;
  - 4 years of financial data;<sup>6</sup> and
  - a full description of the purposes and the activities of the entity.

After receiving tax-exempt recognition, many entities must annually file a Form 990 to report their financial transactions and activities for a “tax year” (see app. II for a copy of Form 990) if annual gross receipts are normally more the \$25,000. Those that have less than \$100,000 in gross receipts and year-end assets of less than \$250,000 may use Form 990-EZ. Generally, entities with gross receipts below \$25,000 are not required to file. Certain types of entities such as churches and religious organizations also are not required to file. Form 990 has information on revenues, expenses, and assets. For 2003, the form had 105 line items on 6 pages as well as 46 pages of instructions plus two schedules. Schedule A covers several areas such as compensation, lobbying, and revenue sources. Schedule B covers the source of contributions to charities and certain other exempt entities, such as IRC Section 527 political organizations.

IRS oversight relies on two activities. First, IRS reviews applications for tax-exempt status to determine whether a tax-exempt purpose is envisioned. IRS can approve or deny the application. Once an application is properly completed, the criterion for approving or denying the exemption is whether the applicant provides sufficient evidence that its operations will match an allowable exempt purpose. Second, IRS annually examines some Forms 990 to determine whether selected exempt entities meet various requirements (such as restrictions on political activities). In general, IRS attempts to select entities that it believes are likely to have violated requirements. IRS can accept the Form 990 as filed or change the

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<sup>6</sup> If the entity has operated for less than a year or has not begun operations, a proposed budget for two full accounting periods and a current statement of assets and liabilities will be acceptable. Otherwise, entities that have operated for less than 4 years should report data for those years.



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status of the entity, impose excise taxes for certain types of violations, or revoke the exempt status if the violations are serious enough. IRS can also assess taxes if an entity has not fully paid employment taxes or taxes on unrelated business income.

Given concerns about the tax-exempt sector, the Senate Committee on Finance asked that a panel of experts make recommendations to Congress to improve oversight, transparency, and governance in the sector. To do so, the Independent Sector<sup>7</sup> convened a Nonprofit Sector Panel in October 2004, which includes 24 nonprofit and philanthropic leaders.<sup>8</sup> It provided an interim report of findings and recommendations in March 2005 and plans to issue a final report in June 2005.

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## Tax-Exempt Assets, Revenues, and Expenses Have Grown, Making It A Significant Sector In The Nation's Economy

The tax-exempt sector is growing. During 1998 through 2002, more entities have been filing Forms 990 and reporting higher amounts of assets, revenues, and expenses. These reported amounts indicate that the tax-exempt sector is a significant part of the economy and the civilian workforce.

The data on the growth in assets, revenues, and expenses reported on the annual Form 990 are likely to be understated because not all tax-exempt entities under section 501(c) are included. Entities below certain asset or gross receipt tolerances are not required to file. Nor are various types of religious entities. Further, an unknown number of tax-exempt entities do not file the required Form 990. The number and finances of those not included are unknown.

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## Tax-Exempt Entities Have Reported Increased Assets, Revenues, and Expenses

For tax years 1998 through 2002, the number of section 501(c) exempt entities filing a Form 990 grew from about 450,000 to 465,000—about 3 percent (see table 1 in app. III). These Forms 990—of which between 63 and 65 percent are filed by charities—have been reporting higher asset amounts. Figure 1 shows the growth in reported assets for tax years 1998 to 2002 (the most recent year of data). The reported assets grew 15 percent

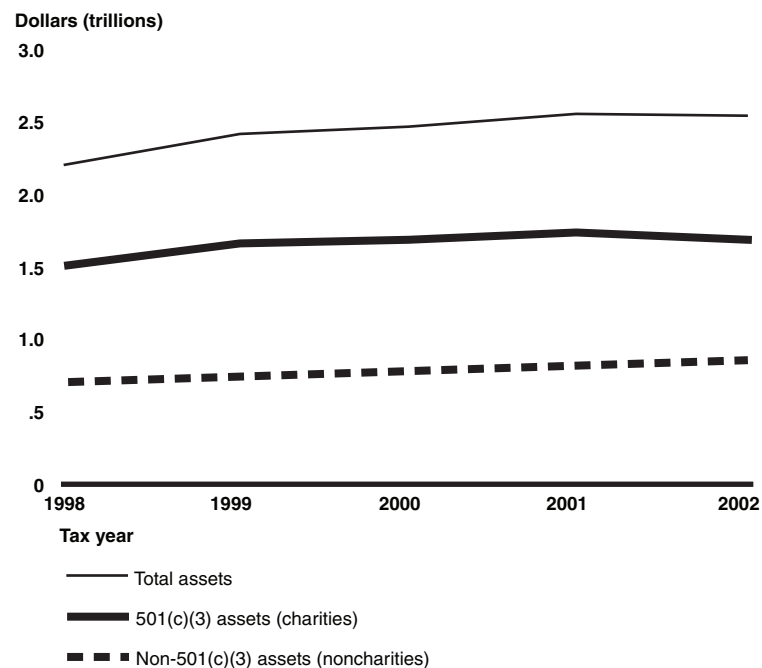
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<sup>7</sup> The Independent Sector is a national coalition of nonprofit organizations, private foundations, and corporate-giving programs that is to support the tax-exempt sector.

<sup>8</sup> The panel is assisted by over 100 nonprofit executives and other experts on five work groups.

to over \$2.5 trillion—about 12 percent growth for section 501(c)(3) charities and about 22 percent growth for the other 27 types of noncharities covered under section 501(c). (See table 2 in app. III.)

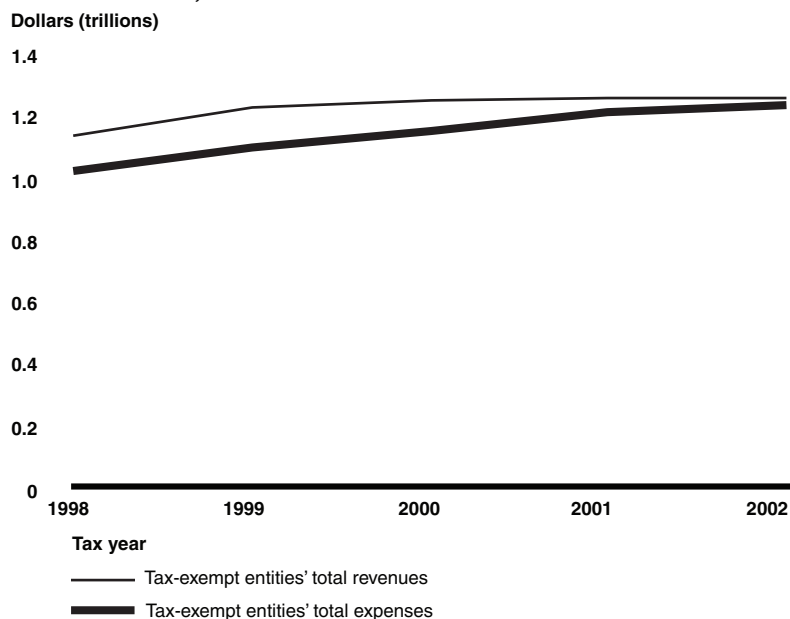
**Figure 1: Assets Reported by Section 501(c) Entities in 2004 Constant Dollars, Tax Years 1998-2002**



Source: Tabulation of data from IRS's Return Inventory Classification System, 1998-2002.

The reported revenue and expense amounts also grew from tax years 1998 through 2002 (see tables 3 and 4 in app. III). However, the amount by which reported revenues exceeded expenses has been closing for exempt entities filing Forms 990—from about 9 percentage points in 1998 to 2 percentage points in 2002 (see fig. 2).

**Figure 2: Revenue and Expenses Reported by Section 501(c) Entities in 2004  
Constant Dollars, Tax Years 1998-2002**



Source: Tabulation of data from IRS's Return Inventory Classification System, 1998-2002.

## Tax-Exempt Sector Is a Significant Part of the Economy and Civilian Workforce

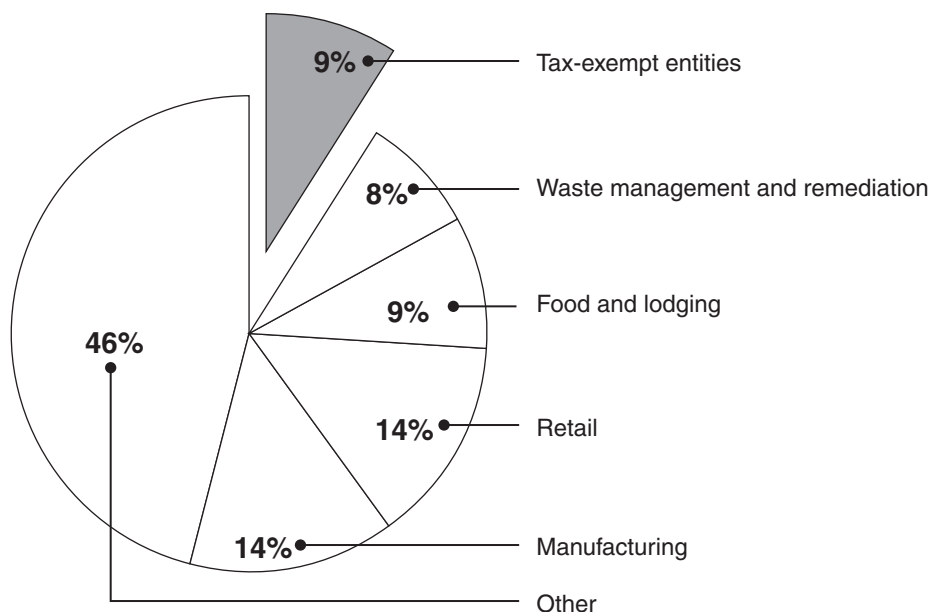
The growth in the tax-exempt sector indicates that it has become a major part of our economy and workforce. From 1975 to 1995, the real assets of entities filing Forms 990 more than tripled while the economy grew 74 percent during the same 20-year period, according to an IRS study.<sup>9</sup> More recently, based on data reported on Forms 990 during 1998 through 2002, spending by tax-exempt entities was roughly 11 to 12 percent of the U.S.'s gross domestic product (GDP).<sup>10</sup> (See table 5 in app. III.) Because the tax-exempt sector is not measured as a specified GDP sector, its percentage of GDP cannot be compared to official GDP sectors such as medical care or housing, which likely include spending by tax-exempt entities. Even so, no single sector accounted for more than 15 percent of the GDP in 2002.

<sup>9</sup> *A 20-Year Review of the Nonprofit Sector, 1975-1995*, Compendium of Studies of Tax-exempt Organizations, Volume 3, IRS Statistics of Income.

<sup>10</sup> Gross domestic product is the market value of all goods and services produced within a country during a given time period.

Figure 3 indicates that tax-exempt entities appear to account for a major portion of the civilian workforce. Data from the U.S. Census indicates that over 9.6 million employees in the tax-exempt sector accounted for about 9 percent of the civilian workforce in 2002. Although generally aligned with section 501(c), the Census definition of a tax-exempt entity excluded certain types of entities (such as universities, labor unions, religious organizations, and public administration), which means that the number of tax-exempt employees is understated.

**Figure 3: Paid Employees by Economic Sector as Percentage of U.S. Workforce, 2002**



Source: U.S. Bureau of the Census, 2002 Economic Census.

Note: "Other" category includes 13 economic sectors that individually accounted for less than 8 percent of the workforce in 2002, including educational services such as technical, driving, and other specialized training schools; mining; utilities; construction; and real estate.

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In addition to paid workers, one study<sup>11</sup> suggests that the number of volunteers at certain tax-exempt entities (which account for at least 60 percent of the sector) grew about 27 percent from 4.5 million in 1982 to 5.7 million volunteers in 1998.

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## Strong Self-governance And Transparency Are Essential Elements For A Thriving And Effective Exempt Sector

Strong self-governance and transparency are essential elements to help provide assurance that tax-exempt entities operate with integrity and effectiveness in meeting their missions while maintaining public trust. A number of requirements help establish governing structures while required public disclosure of information about exempt entities enhances transparency. However, recent concerns about abuses in the tax-exempt sector have prompted consideration of and support for enhanced governance and transparency.

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## Good Governance Helps Provide Assurance that a Tax-Exempt Entity Effectively Manages Funding and Programs

Governance can be viewed as the collective policies and oversight mechanisms in place to establish and maintain sustainable and accountable organizations that achieve their missions while demonstrating stewardship over resources. Good governance helps ensure that tax-exempt entities are well run and that abusive behavior is minimized. Generally, an organization's board of directors has a key role in governance through its oversight of executive management, corporate strategy, risk management and audit processes, and communications with external stakeholders. This is implicitly recognized in some of the statutory and regulatory requirements for the tax-exempt sector.

For example, to obtain federal tax-exempt recognition, applying entities must include charters and bylaws with their application. The states in which they are established specify what must be included in the charters and/or bylaws and the states' requirements help create a basic governance structure for exempt entities. Some states, for instance, have requirements for audited financial statements of tax-exempt entities. For example, in one state, charities with gross revenue in excess of \$100,000 and not more than \$250,000 are required to file financial statements accompanied by a

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<sup>11</sup>IRS does not transcribe data on the numbers of paid workers and volunteers. The Independent Sector issued a nonprofit almanac with data through 1998 on volunteers at entities classified as 501(c) (3) charities, 501(c) (4) social welfare and civic organizations, and religious congregations.

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report from a licensed certified public accountant. If gross revenues exceed \$250,000, the state requires an audited financial statement with an independent auditor's report.

In addition, Congress and IRS have various requirements to help ensure that tax-exempt entities do not engage in activities that are inconsistent with their exempt purpose and to promote stewardship over the use of the funds. For instance, to ensure that tax-exempt assets are for public rather than private benefit, IRS has issued regulations affecting tax-exempt entities on "excessive compensation" to officers, directors, or other employees. IRS requires market comparability studies and a review of compensation by boards of directors. If excessive compensation is found, excise taxes under section 4958 for charities and section 4941 for private foundations can be levied against the overpaid individual and certain managers who knowingly approved the payments. (See app. V for an explanation of such excise taxes imposed against private foundations and other tax-exempt entities.)

The federal government also has certain accountability requirements that affect some tax-exempt entities. OMB Circular A-133, for instance, requires those entities, including tax-exempt entities that receive federal awards of \$500,000 or more per year, to perform an audit of federal funds received and expended and of the programs for which the funds were received.

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## Transparency Complements Good Governance

While strong governance practices can help ensure that tax-exempt entities operate effectively and with integrity, public availability of key information about the entities—i.e., transparency—can both enhance incentives for ethical and effective operations and support public oversight of tax-exempt entities, while helping to achieve and maintain public trust. Recognizing the importance of transparency for tax-exempt entities, Congress provided for substantial transparency regarding tax-exempt entities by making their Forms 990 publicly available documents. This is in stark contrast to the strong protections for the privacy of individuals' tax returns.

Since tax exemptions are granted to entities so that they can carry out particular missions or activities that Congress judged to be of special value, the public availability of the entities' Forms 990 is one means to help ensure that the public has information to judge whether those missions are carried out properly. Presumably, when "sunshine" is let in, inappropriate activities are less likely to occur. In the particular case of charitable organizations, the availability of their Forms 990 provides some

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information for individuals to use in judging whether to make a donation. Thus, publicly available information helps establish a “free market” in which charities compete for donations, which should encourage efficiency and effectiveness.

At various times, Congress has reinforced the commitment to transparency over the operations of tax-exempt entities. For instance, when some exempt entities were found to be imposing inappropriate fees or other requirements on those seeking to obtain a copy of their Form 990, Congress modified the law to provide that copies must be provided without charge to the individual other than a reasonable fee for any reproduction and mailing costs.<sup>12</sup>

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### Recent Concerns about Abuses Have Led to Support for Enhanced Governance Processes and Transparency

With recent concerns about abuses in the tax-exempt sector, attention has been renewed on improving the sector’s governance and transparency. Among the proposals being considered for improved governance are enhancing the controls and processes for determining executive compensation, guarding against other misuse of charitable assets, and forestalling tax-exempt entities’ participation in tax avoidance schemes. Proposals for enhanced transparency include requiring more information in a more timely and user-friendly fashion on the Form 990.

In recent years, media accounts have publicized certain alleged abuses in the tax-exempt sector that speak to failures in tax-exempt entities’ governance. For example, a series of articles in 2003 highlighted possible misuse of foundations and trusts, citing numerous cases of excess compensation, insider loans, self-dealing, extravagant perks, and other questionable activities.<sup>13</sup> The articles cited, for instance, alleged abuses such as:

- A foundation in New York more than tripled its president's compensation to over \$900,000 between 1997 and 2001.

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<sup>12</sup> See IRC Section 6104(d) and changes made by the Tax and Trade Relief Extension Act of 1998, P.L. 105-277.

<sup>13</sup> The *Boston Globe* ran a series of articles between October and December of 2003 that uncovered questionable practices among foundations and trusts.

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- A family-based foundation in Chicago paid two family members over \$1 million during a 5-year stretch and donated only \$175,000 to charities.

Another series of articles pointed to the apparent misuse of easements.<sup>14</sup> An easement is when an owner voluntarily restricts changes to real property, such as to preserve historic buildings and the environment. Donation of the easement to an exempt entity provides an income-tax break to the donor. In some cases, insiders at the charities charged with policing the restrictions imposed by the easements on development may have benefited the most. In other cases, individuals may have claimed tax deductions for easement donations even though local or other laws already required preservation of the property.

Concerns about excessive compensation and whether some tax-exempt entities provide sufficient services to justify their exempt status have surfaced regarding nonprofit hospitals. An example of concerns in these areas has been offered by the Minnesota Attorney General who recently testified on such abuses.<sup>15</sup> Among other things, his office found that certain tax-exempt health care systems paid for trips to vacation resorts by executives and board members without a clear business purpose, and that some nonprofit hospitals provided inadequate levels of “charity” care to patients without the resources to pay. Across the United States, little is known about the extent to which these potential abuses involving excess compensation and the level of services provided by nonprofit hospitals occur. More information about the practices employed by exempt entities to compensate executives and others, and by nonprofit hospitals to serve their patients, would be valuable.

Even as these abuses were surfacing, some organizations within the tax-exempt sector were seeking to improve the governance and transparency within the sector. For example, in recent years, the National Association of State Charity Officials (NASCO), the Independent Sector, and the National Committee for Responsive Philanthropy, among others, have called for revisions to the Form 990.

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<sup>14</sup> The *Washington Post* has been running periodic articles about alleged abuses within the tax-exempt sector. The most recent series, in December 2004, concerned the alleged donation of historic facade easements to obtain inflated charitable contributions.

<sup>15</sup> Testimony of Mike Hatch, Attorney General for State of Minnesota, before the Senate Committee on Finance, April 5, 2005.



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Others have taken the initiative to establish self-regulatory standards independent of those set by IRS. For example, the Better Business Bureau has established a seal of approval program to help donors make informed decisions and foster public confidence in charities. Charities participating in the program are to provide documentation that the bureau uses to determine whether its 20 standards have been met. These standards address governance and oversight, effectiveness, finances, and public information materials. For example, 5 standards are used to measure governance and oversight such as through an active and independent governing board, and 7 standards are used to ensure that spending is honest, prudent, and in accordance with fund-raising appeals.

Concerns about abuses in the tax-exempt sector also have spurred congressional interests. This House Committee on Ways and Means' hearing exemplifies that interest. In June 2004, the Senate Committee on Finance released a discussion draft of proposals for tax-exempt reforms. The draft discussed more than three dozen proposals to generate comments about possible legislation. The proposals addressed conflict of interest, federal-state coordination, transparency, governance, best practices, funding for enforcement, among many others. Such proposals mirror similar types of recent requirements to increase accountability and oversight of other types of large public and private organizations, such as corporations, in which ethical, financial, and other abuses have occurred.

The Panel on the Nonprofit Sector responded to such proposals in its March 2005 interim report. In discussing governance and ethical conduct, the report pointed to the need for best practices, accepted standards, self-regulation, and education. To improve governance, the report recommended that charities enforce a conflict-of-interest policy, select board members with some financial literacy, and encourage disclosure of illegal practices. The report also advocated more transparency to enable public oversight and confidence in tax-exempt entities. It concluded that IRS should promote transparency while recognizing the burdens that reporting more data can place on exempt entities that are small and lack resources. The report supported revising the Form 990, mandating electronic filing in coordination with the states for the Forms 990 and 1023, and increasing the sanctions for not filing an accurate or timely Form 990. The report acknowledged that these steps would not fully dissuade those who want to violate standards, and concluded that some government oversight is necessary.

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More specifically, among the proposals being considered to improve governance and transparency are:

- Governance proposals:
  - Require that compensation for all management positions at a charity must be approved annually and in advance, and must be justified in a manner that can be understood by those with a basic business background.
  - Require the board of directors of a charity to establish a conflict-of-interest policy, a compliance program to address regulatory and liability concerns, and program objectives and performance measures, among other duties.
  - Prohibit board membership to those not permitted to serve on the board of a publicly traded company.
  - Establish a prudent investor rule for the investment activities of charities.
- Transparency proposals:
  - Require the chief executive officer of a tax-exempt entity to sign under penalty of perjury that the Form 990 and other forms filed comply with the Internal Revenue Code and that reasonable assurances were given of the accuracy and completeness of the information reported.
  - Require disclosure of relationships of a tax-exempt entity with other exempt and nonexempt entities, including the formation of taxable subsidiaries and transactions with these other entities.
  - Require disclosure of annual performance goals and measures by charities with over \$250,000 in gross receipts.
  - Require disclosure of investments by public charities.

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## IRS Has Been Challenged to Oversee Tax-Exempt Entities and Is Beginning Steps to Enhance Its Oversight Capacity

Staffing and insufficient data have constrained IRS's oversight of the tax-exempt sector. IRS is in the midst of increasing tax-exempt staffing in fiscal year 2005 and improving its data on tax-exempt entities as well as enhancing its ability to analyze data to help in targeting compliance efforts. IRS has identified compliance problems it deems critical and is taking actions to address them.

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## IRS Oversight Resources Have Been Relatively Flat Until Recently

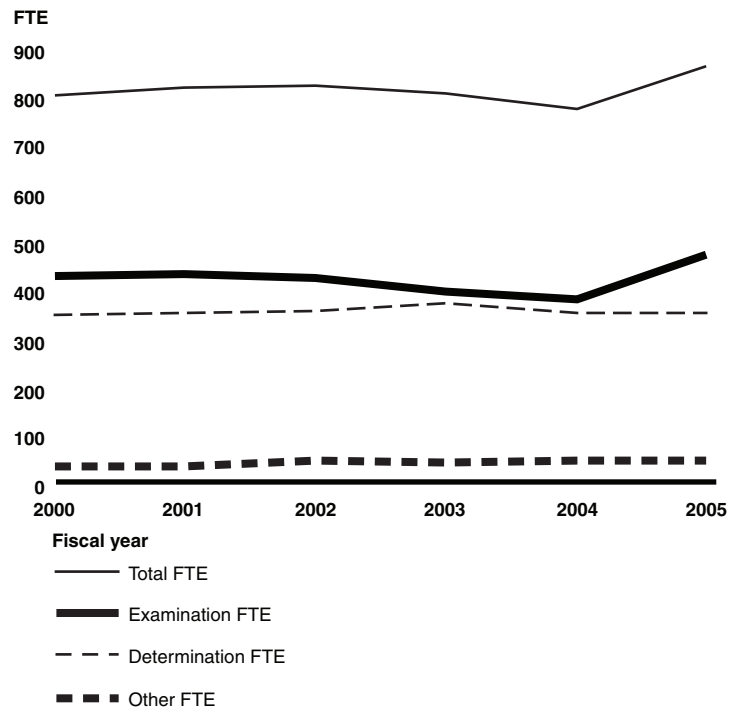
Based on a 1997 IRS memorandum and more recent data, it is apparent that the staffing level for the functions that are now within the Tax Exempt and Governmental Entities (TE/GE) division has been essentially flat since 1974—2,075 in 1974 versus 2,122 in 2004. These are total staffing levels for all of the work done within the current TE/GE, which includes reviewing employee pension plan issues and certain other matters. Although we did not obtain a measure of the overall change in TE/GE workload from 1974 to 2004, the number of 501(c) tax-exempt entities increased from around 670,000 to over 1.5 million.

From fiscal year 2000 through 2004, IRS staffing for overseeing tax-exempt entities stayed relatively flat as measured by the number of FTE staff assigned to oversee tax-exempt entities.<sup>16</sup> For fiscal year 2005, IRS increased the number of FTEs assigned for such work. The assigned FTEs dropped about 4 percent from fiscal years 2000 through 2004 but increased about 11 percent for fiscal year 2005, resulting in a 7 percent increase in assigned FTEs overall (see fig. 4). This 2005 increase is due to the FTEs assigned to do examinations since the FTEs assigned to do determinations of exempt status stayed relatively flat. As of 2005, IRS assigned 467 FTEs to examine the hundreds of thousands of entities who generally file Forms 990 (see table 6 in app. IV).

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<sup>16</sup> An FTE equals 2,087 hours in a year. IRS did not have comparable FTE data for its exempt activities back to 1998 due to its reorganization in 2000. FTEs assigned are what IRS budgets for this work. We were unable to obtain reliable data on the FTEs used for tax-exempt oversight in time for this testimony. However, because IRS may not use the FTEs assigned to examination or determinations for those purposes, the number of hours that staff charge to these oversight tasks may be a better indicator of the level of effort.

**Figure 4: Assigned FTEs by Type of IRS Activity, Fiscal Years 2000-2005**



Source: IRS Exempt Organization officials.

Note: "Other FTE" includes technical staff who issue rulings, the Director's staff, and education and outreach.

Competition within IRS for resources helps explain why resources for tax-exempt oversight have not increased much until fiscal year 2005. IRS has many other priorities in collecting the proper amount of tax from tens of millions of individuals and businesses. IRS's budget emphasizes areas that produce tax revenue rather than areas that are regulatory. IRS oversight of the exempt sector is primarily regulatory rather than revenue producing. IRS exempt officials also said that an ongoing issue is the proper mix of resources budgeted for oversight versus other activities such as providing guidance or education. Beyond tax-exempt entities, TE/GE must also budget resources to deal with pension plans, Indian tribal governments, and other types of government entities.

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Congressional tax-writing committees have attempted to provide dedicated funding for exempt oversight. For example, in 1969, Congress added section 4940 to the Internal Revenue Code, which imposes an excise tax on the net investment income of private foundations (see app. V for an explanation of this tax and tax rates). The legislative history indicates that the tax committees intended for the amounts collected from the excise taxes would operate as user fees to fund IRS oversight of exempt entities. To date, congressional appropriation committees, which have jurisdiction over annual funding, have not earmarked these tax collections for this purpose.<sup>17</sup>

IRS has not maintained data on how much excise tax it has assessed or collected under Section 4940 (or any other excise tax that can be assessed against tax-exempt entities either overall or by type of excise tax). However, IRS did have data that showed tax-exempt entities reported owing (i.e., self-assessed), in 2004 constant dollars, at least \$247 million in this excise tax annually (about \$1.5 billion overall) for 2000 through 2003 (see table 10 in app. V). For comparison, the fiscal year 2003 budget for all of TE/GE (i.e., not just tax-exempt oversight functions) was around \$205 million.

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### IRS's Oversight Caseload Has Been Increasing in Recent Years and IRS Has Had Difficulties Sustaining Its Oversight

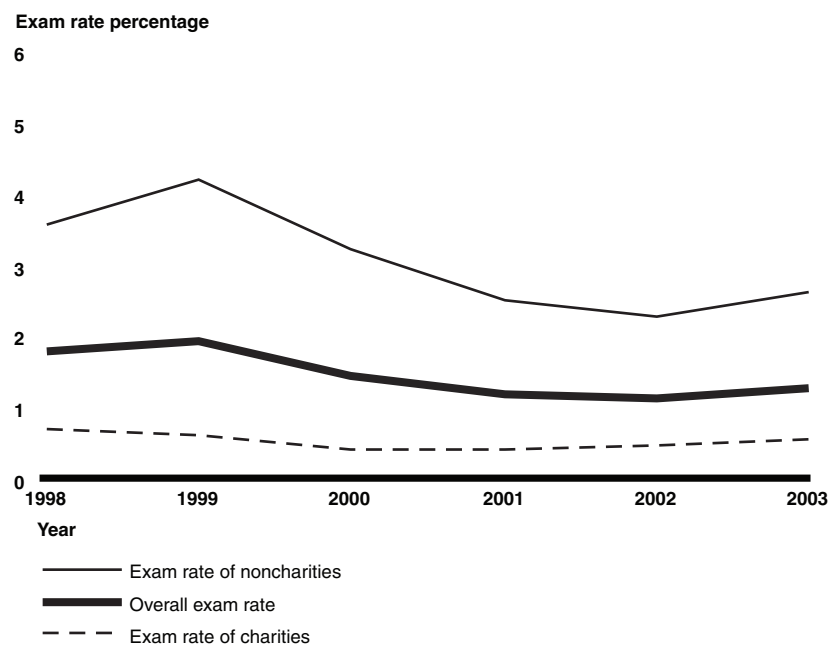
For section 501(c) entities, IRS's oversight caseload has been increasing. In its determinations' work involving applications for tax-exempt status, in fiscal years 1998 through 2004, applications increased about 17 percent from 78,358 to 87,080, with some annual fluctuations (see table 7 in app. IV). IRS officials said that IRS must review each application to make a determination of exempt status. IRS's potential tax-exempt examination universe has grown more slowly. As mentioned earlier, the number of exempt entities filing a Form 990 grew from about 450,000 to 465,000 during tax years 1998 through 2002—or about 3 percent.

IRS has had difficulty sustaining a consistent examination rate for tax-exempt entities. As figure 5 shows, the rate at which IRS examined filed Forms 990 fell from 1.8 percent in 1998 to 1.1 percent in 2002 before rising to 1.3 percent in 2003 (see table 8 in app. IV).

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<sup>17</sup>The Nonprofit Sector Panel interim report concluded that Congress should increase resources, and earmark some penalty, fee, and excise tax amounts for IRS exempt oversight and education.

**Figure 5: IRS Examination Rates for Section 501(c) Entities, Fiscal Years 1998-2003**



Source: GAO tabulation of IRS's Audit Information Management System and IRS's Return Inventory Classification System, 1997-2002.

IRS officials said that the declining examination rates primarily resulted from a decline in FTEs for examinations and an increase in the average hours spent per examination. The number of tax-exempt entities that IRS examined decreased from 8,290 in fiscal year 1998 to 5,889 in 2004, or about 29 percent, after dropping as low as 5,423 examinations in 2002. IRS officials said that they have examined more returns since 2002 because they used more of their examiners to examine Forms 990 rather than help elsewhere such as with determinations, and expedited examinations, such as by limiting their scope and depth.

In terms of determinations' results, during fiscal years 1998 through 2004, IRS annually denied about 1 percent of the applications while the approval rate was 74-80 percent (see table 7 in app. IV).<sup>18</sup> Denials occur when IRS determines that an applicant has not met the statutory requirements for

<sup>18</sup>The rest of the applications included those for which IRS had not made a determination for reasons such as applications that were withdrawn or incomplete.

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exemption. In accordance with the statutory guidance on qualifying for tax-exempt status, IRS is not likely to deny the recognition of tax-exempt status as long as the applicant provides all required documents, files a complete Form 1023, and provides an appropriate statement about its intent to serve an approved exempt purpose.

Regarding examination results, during fiscal years 1998 through 2003, IRS revoked exempt status in 1.2 percent of its examinations. Revocations occur when IRS determines that the entity omitted or misstated a material fact, operated materially different from its stated exempt purpose, or engaged in a prohibited transaction in conflict with its exempt purpose. IRS does not often revoke tax-exempt status because the need for revocation often does not arise and when it does, IRS focuses more on getting the tax-exempt entity to comply with federal laws rather than on taking away its exempt status.

Beyond revocations, IRS examinations can produce one or more other changes<sup>19</sup> such as in the section 501(c) paragraph,<sup>20</sup> foundation status of a 501(c)(3) entity,<sup>21</sup> and assessed tax.<sup>22</sup> Changes in paragraph are important because of rules governing permissible activities. For example, a tax-exempt entity classified as a charity under 501(c)(3) can accept donations that are tax deductible for the donor, unlike those classified as a social welfare entity under Section 501(c)(4). However, such charities are more restricted in their ability to lobby and engage in political activity compared to social welfare entities. Changes in foundation status are important because foundations generally are subjected to more requirements than

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<sup>19</sup>IRS examiners can make 12 “other” types of changes such as those involving related returns, delinquent returns, appeals, closing agreements, referrals to other IRS divisions, and claims.

<sup>20</sup> “Paragraph” refers to the types of 501(c) entities such as (c)(3) or (c)(4). When an entity applies for exempt status, it must tell IRS the section 501(c) paragraph under which it qualifies.

<sup>21</sup> An entity that qualifies under section 501(c)(3) is a private foundation unless it meets the criteria for a public charity, such as having broad public support. Beyond an examination, status can be changed when (a) an entity requests an IRS determination letter on its status, and (b) 5 years have elapsed for an entity that has been permitted to be a public charity for its first 5 years.

<sup>22</sup> Tax-exempt entities could owe employment taxes, various types of excise taxes, or income taxes if they operate a business activity not related to their exempt purpose.

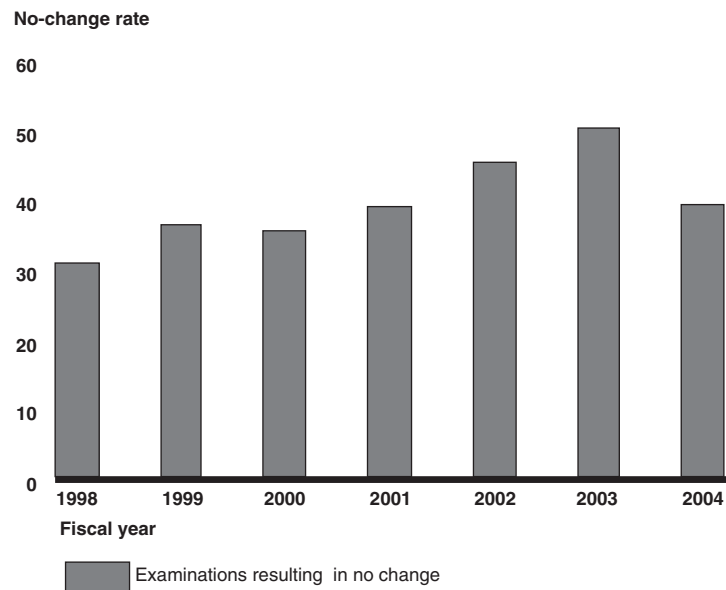
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public charities, such as in the requirement to annually distribute a minimum amount of income towards its exempt purpose.

Figure 6 shows that the percentage of examinations that produced no change rose from 31 percent in fiscal year 1998 to 39 percent in 2004, with higher rates in 2002 and 2003 (see table 9 in app. IV). In general, IRS is not likely to find a change in every examination given the focus on getting exempt entities into compliance and the need for better data to select the most noncompliant entities for examination. Higher no-change rates mean that IRS spends resources examining compliant entities. IRS officials said that they are working to reduce the no-change rate to or below the 1998 level.

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**Figure 6: No-Change Rate for Examinations of Forms 990, Fiscal Years 1998-2004**



Source: Tabulation of data from IRS's Audit Information Management System, 1998-2004.

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### IRS Has Had Insufficient Reliable Information to Guide Oversight Efforts but Is Working to Obtain Better Information

IRS has acknowledged that it lacks sufficient data to effectively find and address noncompliance among tax-exempt entities. At the same time, IRS is aware that improvement to the Form 990 data made available to the public could better support public, media, and others' oversight of tax-exempt entities. To better enable it to collect and analyze such data, IRS is



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taking a number of steps. IRS is also trying different actions to enhance its ability to address critical and other types of noncompliance.

To help identify noncompliance, IRS is revising the data requested on the Form 990. IRS has determined that the Form 990 does not provide sufficient data to identify tax-exempt entities that merit an examination due to noncompliance. Nor can IRS easily compare Form 990 data with data reported on the Form 1023.<sup>23</sup> For example, the current Form 1023 requests data on hospitals and low-income housing that are not captured in the Form 990. Being able to compare similar data on both forms would better enable IRS to see whether the stated exempt purpose is being pursued and met.

To enhance the usefulness and ease of preparation of the Form 990, IRS officials stated that the IRS is undertaking a large-scale revision. IRS officials said that the revision process has key steps to be taken before IRS shares the specific changes. However, IRS officials identified some general changes being developed. To ease preparation, IRS is attempting to write all questions in plain English and group questions related to an issue. Further, IRS officials explained that the revised Form 990 is to consist of one form applicable to all tax-exempt entities and a series of organization and activity schedules. The organization schedules would be tailored to filers such as hospitals or veteran's organizations while the activity schedules would be tailored to issues such as compensation packages and grant making that may be financing terrorism.

An IRS team completed a first draft of the revised Form 990 in December 2004. Before setting milestones for publishing the Form 990, IRS wants to allow for review by various parties inside and outside IRS. IRS also plans to consider recommendations on the Form 990 of the Nonprofit Sector Panel to be presented in its final report in June 2005. Finally, IRS plans to make the revised Form 990 suitable for electronic filing in a cost-effective manner.

IRS has also recognized that it has insufficient data on the extent or causes of noncompliance for segments of the tax-exempt sector. IRS has done a few studies to measure the compliance of exempt entities filing Forms 990

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<sup>23</sup>IRS revised Form 1023 in 2004 to provide information that helps identify potential problems early in the application process, including potentially abusive situations involving tax-exempt entities such as those claiming to provide credit counseling.

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and reporting items such as the unrelated business income tax owed. IRS did these studies in the 1970s, except for a smaller compliance study done during the 1980s.

To alleviate such data shortcomings, in 2002, IRS began over 30 studies of “market segments,” which are homogeneous groups of tax-exempt entities such as charities, social clubs, and business leagues, or of exempt issues such as business income unrelated to an exempt purpose. These studies were to develop reliable data on the types and extent of compliance problems. IRS planned to use the data to refine selection criteria for identifying noncompliant returns for examination as well as help identify other strategies to improve compliance such as through improved guidance or instructions. However, IRS has had to delay most of these studies due to higher priorities (such as dealing with abusive tax transactions).

Given its concern about insufficient data, IRS also is taking steps in fiscal year 2005 to improve its capabilities to analyze data. IRS has been establishing a Data Analysis Unit to provide trend analysis intended to improve the selection of tax-exempt entities for examination and the identification of compliance issues to pursue. The unit is to make better use of internal and external databases.<sup>24</sup> A driving force in creating the unit was the lack of research tools and staff trained in using data. As described below, IRS has several other efforts underway or planned to improve the use of electronic data on the tax-exempt sector.

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<sup>24</sup> The Data Analysis Unit plans to use data-mining techniques to identify patterns and establish relationships to uncover compliance issues. For example, by comparing state bingo databases to IRS files, IRS could identify entities with gross receipts in excess of the \$25,000 filing threshold that failed to file a required Form 990.

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- IRS plans to expand electronic filing of returns, which could help IRS to more quickly identify noncompliance and improve public access to Form 990 data.<sup>25</sup> IRS began accepting the Form 990<sup>26</sup> electronically on a voluntary basis in 2004, and plans to expand voluntary electronic filing to Form 990-PF filed by private foundations in 2005 and to create a single point for electronic filing of federal and state returns in 2006. IRS plans to require electronic Form 990 filing for exempt organizations with assets in excess of \$100 million for 2006 and in excess of \$10 million for 2007. Private foundations would be required to file electronically for 2007 regardless of the amount of their assets.<sup>27</sup>
  - IRS's Exempt Organizations Electronic Initiatives Office<sup>28</sup> is developing a "Better Data Initiative" intended to synthesize IRS's electronic data for compliance purposes, such as examination selection and compliance trend analysis. The goal is to have an effective database management infrastructure in place by 2007. This office also is to help find and use electronic data sources that would be useful for trend analysis.

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## IRS Has Identified Priority Compliance Issues and Is Working to Address Them

Because of increasing concerns about specific types of noncompliance, IRS has created initiatives to address specific abuses across the tax-exempt sector. IRS also is attempting to build a stronger enforcement presence during 2005 through new processes to supplement examinations of compliance among exempt entities.

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<sup>25</sup> IRS has a network to image the paper Forms 990 filed by charities. The imaged forms, minus sensitive data such as social security numbers and donor names, are sold to groups that want such data. Due to resource limitations, IRS transcribes little data from Forms 990 into electronic databases. To have more electronic data from Forms 990, IRS has a contract to have the imaged Form 990 data keypunched.

<sup>26</sup> IRS is developing electronic filing for Form 1023, which is used to apply for tax-exempt status. IRS hopes to begin accepting the electronic Form 1023 by 2007.

<sup>27</sup> Consistent with IRC section 6011(e), only large organizations, including exempt organizations and private foundations, that are required to file 250 or more returns with IRS will be required to file their Form 990 electronically. Such returns include Forms 990, annual employee wage and tax statements (Form W-2), quarterly payroll tax returns (Form 941), and annual information returns, such as payments to vendors for services (Form 1099 MISC).

<sup>28</sup> The Electronic Initiatives Office manages the development and implementation of automation efforts on exempt organizations in support of the strategic plan.

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IRS has identified four critical compliance problems, which it plans to address through enforcement during fiscal year 2005, as follows.

- Anti-terrorism—examine a sample of exempt entities that make foreign grants to ensure that the funds are used for the charitable purpose and not for terrorist activity.
- Credit counseling—examine credit counseling and consumer credit organizations that appear to operate as businesses rather than provide the educational or charitable services required under tax-exempt status.
- Excessive compensation—conduct compliance checks and examinations of charities and private foundations to identify potential excessive compensation paid to insiders.
- Abusive tax avoidance transactions—focus on four types of transactions that are intended to exploit tax-exempt status for personal gains, including:
  - using non-life mutual insurance companies<sup>29</sup> and producer-owned reinsurance companies<sup>30</sup> to earn tax-free profits;
  - establishing donor-advised funds<sup>31</sup> to generate questionable deductions, benefits to donors, or management fees for promoters;
  - misusing tax-exempt entities that are to support other exempt entities by, for example, making large loans to the founder of the supported entity or by not providing the required tax-exempt support; and
  - abusing Department of Housing and Urban Development programs such as through personal use of program property.

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<sup>29</sup> Insurance companies or associations that provide other than life insurance are generally tax exempt under IRC section 501(c)(15) if their gross receipts do not exceed \$600,000 and more than 50 percent of their receipts consist of premiums.

<sup>30</sup> A producer-owned reinsurance company provides reinsurance for a producer group's business; reinsurance transfers part or all of the risk from one insurer to another.

<sup>31</sup> Donor-advised funds allow donors to advise how the charitable contribution is to be used.

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IRS plans to address other compliance problems as well. The problems to be addressed involve charitable gaming, disaster relief organizations whose distributions result in private benefit or fraud, tax-exempt political organizations that fail to annually report all required information, and prohibited political intervention by charities.<sup>32</sup> In addition, IRS is addressing excess deductions for conservation easements, vehicle donations, and other noncash contributions, as well as abuses involving charitable trusts, and a “corporation sole”.<sup>33</sup>

To enhance enforcement overall, IRS has been developing new units or processes. For example, IRS created the Exempt Organization Compliance Unit in 2004 to help deal with growth in the number of tax-exempt entities coupled with the limited examination resources. It is to check exempt entities’ compliance with record-keeping and information-reporting requirements via correspondence rather than a review of books and records in an examination. During fiscal year 2004, the unit sent over 2,000 letters to check compliance and over 8,000 letters to educate the entities about how to comply. If an entity does not respond or has questionable activity identified in the compliance check, IRS could initiate an examination.

IRS also is developing a Financial Investigations Unit to specialize in complex fraud and tax-avoidance schemes involving the exempt sector. IRS recognized that it lacked staff in its tax-exempt unit trained to trace funds through complex transactions but was being asked to ensure that charitable assets are not diverted for illegal purposes. IRS plans to hire specialists that can identify fraud and track foreign grants. Furthermore, IRS has established a group to review exempt applications for names of individuals that appear on a Department of the Treasury Office of Foreign Assets Control listing of suspected terrorists or that IRS knows to be tax-scheme promoters as well as for types of entities with a history of noncompliance, such as in credit counseling. The presence of such names or entities would likely result in a referral to the examination group, or for a suspected terrorist, to IRS Criminal Investigation group.

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<sup>32</sup> IRS plans to contact over 100 charities identified as having potentially violated the prohibition, to educate the organizations and prevent future violations of the law.

<sup>33</sup> A corporation sole is an entity authorized under state law to allow religious leaders to hold property and conduct business for the benefit of a religious entity.

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## States Play an Important Role in Overseeing Tax-Exempt Entities and May Benefit from Additional Coordination With IRS

In addition to IRS oversight, states oversee tax-exempt entities, often focusing on potential fund-raising fraud and misuse of charitable assets. The states believe that their oversight could be more effective if IRS were able to share additional information with them. We have previously recommended that IRS work with states on data-sharing proposals that Congress could consider.

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## States Provide Critical Oversight

Many states oversee some aspects of the tax-exempt sector through their attorney general and/or state charity offices. Although some overlap in responsibility with IRS exists, state oversight differs. IRS focuses on whether the tax-exempt entities meet tax-exempt requirements and comply with federal laws. States have an interest in whether tax-exempt charities' fund-raising is fraudulent and whether the entity is meeting the purpose for which it was created.

In general, exempt entities are to incorporate in a state or the District of Columbia. State attorneys general have broad power to regulate the charities that are established or operate in their states. States monitor charities for compliance with statutory and common-law standards, and can correct noncompliance through litigation and other means.

States can impose requirements on tax-exempt entities incorporated or operating in their jurisdictions that specifically affect governance or transparency. For example, some states require fund-raisers to register and file information regarding fund-raising or monitor charity solicitations through their consumer protection bureaus to protect against fraud. Through its Nonprofit Integrity Act of 2004, California established governance requirements for financial audits, audit committees, disclosure of audited statements, and review and approval by the board of directors of compensation paid to the chief executive officer and chief financial officer. The act also established requirements related to fundraising.

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## Coordination between IRS and the States in Sharing Data About Tax-Exempt Entities Could Enhance Oversight and the Use of Limited Resources

State officials believe, and IRS officials agree, that state oversight of tax-exempt entities could benefit if IRS and states coordinated on sharing IRS's data. IRS is working on improved data sharing consistent with recommendations we made in 2002.<sup>34</sup> First, we recommended that IRS consult with state charity officials on how to regularly share IRS data that federal law allowed to be shared (e.g., data on denials or revocations of tax-exempt status). State charity officials told us that IRS has implemented this recommendation and has been open to input from the states on how to better share the data on a regular basis.

Second, we recommended that IRS work with state charity officials and the Department of the Treasury to identify other types of IRS data that states would find useful and provisions to protect the data from improper disclosure or misuse, and to develop a legislative proposal that would expand state access to such IRS data. State and IRS officials believe that revising statutes to allow IRS to share more data, such as about ongoing and closed examinations of charities, would help IRS and states to better use limited resources and the states to more quickly respond to noncompliance. Congress is now considering a proposal to allow IRS to share more information with the states, including their charity regulators.

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## Concluding Observations

Tax-exempt entities provide an incredibly diverse set of services to our equally diverse population. Our lives are enriched and improved through the work of this sector. In sum, the tax-exempt sector has become an indispensable part of American life. Yet, like all organizations run by human beings, tax-exempt entities' operations can at times be flawed.

Ensuring that tax-exempt entities run as effectively and efficiently as possible, and in line with the purposes for which Congress established their tax exemption, can best be accomplished through a series of complementary controls. At the organization level, a sound governance structure can establish the set of checks and balances that help steer an entity towards result-oriented outcomes consistent with their purposes while also guarding against abuses. Transparency over the operations of the exempt entity provides an incentive to help ensure the governance practices function as intended and when they do not, transparency helps increase the chances that inappropriate behavior will be detected and

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<sup>34</sup> See [GAO-02-526](#).

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corrected. Oversight by IRS and the states brings to bear the powers of government to investigate errors made among tax-exempt entities, to change the rules when necessary, and to provide consequences when rules are not followed.

Regarding oversight by states, IRS and states believe greater sharing of federal data would help states target their enforcement efforts and minimize unnecessary overlap with federal oversight of exempt organizations. As we recommended, we look forward to IRS, the Department of the Treasury, and states identifying the specific information that should be shared and procedures for sharing it consistent with taxpayer privacy rights, to help Congress in deliberating changes to current restrictions on IRS sharing such data with the states.

Ultimately, Congress determines what activities should benefit from tax exemption and what organizations must do in exchange for that advantage. Periodic congressional oversight is therefore critical to ensuring that the exempt sector remains a vibrant contributor to the quality of American lives and operates with integrity in achieving results commensurate with the tax-favored status it has been granted. As noted earlier, the hearing today provides an excellent forum from which to launch a comprehensive re-examination of this vital sector as we work to address the challenges arising in the 21<sup>st</sup> century. We stand ready to assist Congress as it considers such a re-examination and continues its oversight of this critical sector of our national economy.

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Mr. Chairman, this concludes my prepared statement. I would be happy to respond to any questions you or other Members of the committee may have.

For further information on this testimony, please contact Michael Brostek at (202 512-9110) or [brostekm@gao.gov](mailto:brostekm@gao.gov). Individuals making key contributions to this testimony include Perry Datwyler, George Guttman, Shirley Jones, Bob McKay, John Mingus, Jeff Schmerling, and Tom Short.



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# Types of Tax-Exempt Entities under Section 501(c)

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The following lists the 28 types of tax-exempt entities under the subsections of section 501(c) of the Internal Revenue Code.

1. Corporations organized by Act of Congress; Central Liquidity Facility for Federal Credit Unions; Resolution Trust Corporation; Resolution Funding Corporation
2. Title-holding corporations
3. Public charities, private foundations, religious, charitable, scientific, testing for public safety, literary, or educational, fostering national or international amateur sports competition, prevention of cruelty to children or animals
4. Civic leagues, social welfare organizations, local associations of employees dedicated to charitable, educational, or recreational purposes
5. Labor unions, agricultural, or horticultural organizations
6. Trade associations, professional football leagues
7. Social and recreational clubs
8. Fraternal benefit societies providing payment of certain benefits to members
9. Voluntary employees' beneficiary associations providing payment of certain employee benefits
10. Domestic fraternal societies whose net earnings are devoted to religious, charitable, scientific, literary, educational, and fraternal purposes, which do not provide benefits to members
11. Teachers' retirement fund associations
12. Benevolent life insurance associations, mutual ditch or irrigation companies, mutual or cooperative telephone, electric, or water companies
13. Cemetery companies

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**Appendix I**  
**Types of Tax-Exempt Entities under Section**  
**501(c)**

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14. Credit unions
15. Small mutual insurance companies
16. Corporations to finance crop operations
17. Supplemental unemployment benefit trusts
18. Pre-June 25, 1959 trusts to fund pension benefits
19. Veterans' groups
20. Group legal service organizations
21. Black lung benefit trusts
22. Multi-employer pension plan trusts
23. Armed Forces insurance organizations established before 1880
24. ERISA trusts for certain terminated plans
25. Multi-parent holding companies
26. State-sponsored, high-risk insurance organizations
27. State-sponsored worker compensation reinsurance organizations
28. National railroad retirement investment trust

# Copy of Form 990

Form **990** **Return of Organization Exempt From Income Tax** OMB No. 1545-0047  
 Under section 501(c), 527, or 4947(a)(1) of the Internal Revenue Code (except black lung benefit trust or private foundation) **2004**  
 Department of the Treasury Internal Revenue Service **Open to Public Inspection**

**A** For the 2004 calendar year, or tax year beginning \_\_\_\_\_, 2004, and ending \_\_\_\_\_, 20

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

**C** Name of organization \_\_\_\_\_  
 Number and street (or P.O. box if mail is not delivered to street address) Room/suite \_\_\_\_\_  
 City or town, state or country, and ZIP + 4 \_\_\_\_\_

**D** Employer identification number \_\_\_\_\_  
**E** Telephone number (\_\_\_\_\_) \_\_\_\_\_  
**F** Accounting method:  Cash  Accrual  Other (specify) \_\_\_\_\_

**G** Website: \_\_\_\_\_

**J** Organization type (check only one)  501(c) ( ) (insert no.)  4947(a)(1) or  527

**K** Check here  if the organization's gross receipts are normally not more than \$25,000. The organization need not file a return with the IRS; but if the organization received a Form 990 Package in the mail, it should file a return without financial data. **Some states require a complete return.**

**L** Gross receipts: Add lines 6b, 8b, 9b, and 10b to line 12

**H and I are not applicable to section 527 organizations.**  
**H(a)** Is this a group return for affiliates?  Yes  No  
**H(b)** If "Yes," enter number of affiliates \_\_\_\_\_  
**H(c)** Are all affiliates included?  Yes  No (If "No," attach a list. See instructions.)  
**H(d)** Is this a separate return filed by an organization covered by a group ruling?  Yes  No  
**I** Group Exemption Number \_\_\_\_\_

**M** Check  if the organization is **not** required to attach Sch. B (Form 990, 990-EZ, or 990-PF).

**Part I Revenue, Expenses, and Changes in Net Assets or Fund Balances** (See page 18 of the instructions.)

Revenue	<b>1</b> Contributions, gifts, grants, and similar amounts received:			
	<b>a</b> Direct public support	<b>1a</b>		
	<b>b</b> Indirect public support	<b>1b</b>		
	<b>c</b> Government contributions (grants)	<b>1c</b>		
	<b>d</b> Total (add lines 1a through 1c) (cash \$ _____ noncash \$ _____)	<b>1d</b>		
	<b>2</b> Program service revenue including government fees and contracts (from Part VII, line 93)	<b>2</b>		
	<b>3</b> Membership dues and assessments	<b>3</b>		
	<b>4</b> Interest on savings and temporary cash investments	<b>4</b>		
	<b>5</b> Dividends and interest from securities	<b>5</b>		
	<b>6a</b> Gross rents	<b>6a</b>		
	<b>b</b> Less: rental expenses	<b>6b</b>		
	<b>c</b> Net rental income or (loss) (subtract line 6b from line 6a)	<b>6c</b>		
<b>7</b> Other investment income (describe _____)	<b>7</b>			
Revenue	<b>8a</b> Gross amount from sales of assets other than inventory	(A) Securities	(B) Other	
	<b>b</b> Less: cost or other basis and sales expenses	<b>8a</b>	<b>8b</b>	
	<b>c</b> Gain or (loss) (attach schedule)	<b>8c</b>		
	<b>d</b> Net gain or (loss) (combine line 8c, columns (A) and (B))	<b>8d</b>		
Revenue	<b>9</b> Special events and activities (attach schedule). If any amount is from gaming, check here <input type="checkbox"/>			
	<b>a</b> Gross revenue (not including \$ _____ of contributions reported on line 1a)	<b>9a</b>		
	<b>b</b> Less: direct expenses other than fundraising expenses	<b>9b</b>		
	<b>c</b> Net income or (loss) from special events (subtract line 9b from line 9a)	<b>9c</b>		
Revenue	<b>10a</b> Gross sales of inventory, less returns and allowances	<b>10a</b>		
	<b>b</b> Less: cost of goods sold	<b>10b</b>		
	<b>c</b> Gross profit or (loss) from sales of inventory (attach schedule) (subtract line 10b from line 10a)	<b>10c</b>		
Revenue	<b>11</b> Other revenue (from Part VII, line 103)	<b>11</b>		
	<b>12</b> Total revenue (add lines 1d, 2, 3, 4, 5, 6c, 7, 8d, 9c, 10c, and 11)	<b>12</b>		
Expenses	<b>13</b> Program services (from line 44, column (B))	<b>13</b>		
	<b>14</b> Management and general (from line 44, column (C))	<b>14</b>		
	<b>15</b> Fundraising (from line 44, column (D))	<b>15</b>		
	<b>16</b> Payments to affiliates (attach schedule)	<b>16</b>		
	<b>17</b> Total expenses (add lines 16 and 44, column (A))	<b>17</b>		
Net Assets	<b>18</b> Excess or (deficit) for the year (subtract line 17 from line 12)	<b>18</b>		
	<b>19</b> Net assets or fund balances at beginning of year (from line 73, column (A))	<b>19</b>		
	<b>20</b> Other changes in net assets or fund balances (attach explanation)	<b>20</b>		
	<b>21</b> Net assets or fund balances at end of year (combine lines 18, 19, and 20)	<b>21</b>		

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**Part II Statement of Functional Expenses** All organizations must complete column (A). Columns (B), (C), and (D) are required for section 501(c)(3) and (4) organizations and section 4947(a)(1) nonexempt charitable trusts but optional for others. (See page 22 of the instructions.)

<i>Do not include amounts reported on line 6b, 8b, 9b, 10b, or 16 of Part I.</i>	(A) Total	(B) Program services	(C) Management and general	(D) Fundraising
<b>22</b> Grants and allocations (attach schedule) . . . . . (cash \$ _____ noncash \$ _____)	<b>22</b>			
<b>23</b> Specific assistance to individuals (attach schedule)	<b>23</b>			
<b>24</b> Benefits paid to or for members (attach schedule)	<b>24</b>			
<b>25</b> Compensation of officers, directors, etc. . . . .	<b>25</b>			
<b>26</b> Other salaries and wages . . . . .	<b>26</b>			
<b>27</b> Pension plan contributions . . . . .	<b>27</b>			
<b>28</b> Other employee benefits . . . . .	<b>28</b>			
<b>29</b> Payroll taxes . . . . .	<b>29</b>			
<b>30</b> Professional fundraising fees . . . . .	<b>30</b>			
<b>31</b> Accounting fees . . . . .	<b>31</b>			
<b>32</b> Legal fees . . . . .	<b>32</b>			
<b>33</b> Supplies . . . . .	<b>33</b>			
<b>34</b> Telephone . . . . .	<b>34</b>			
<b>35</b> Postage and shipping . . . . .	<b>35</b>			
<b>36</b> Occupancy . . . . .	<b>36</b>			
<b>37</b> Equipment rental and maintenance . . . . .	<b>37</b>			
<b>38</b> Printing and publications . . . . .	<b>38</b>			
<b>39</b> Travel . . . . .	<b>39</b>			
<b>40</b> Conferences, conventions, and meetings . . . . .	<b>40</b>			
<b>41</b> Interest . . . . .	<b>41</b>			
<b>42</b> Depreciation, depletion, etc. (attach schedule)	<b>42</b>			
<b>43</b> Other expenses not covered above (itemize): a . . . . .	<b>43a</b>			
b . . . . .	<b>43b</b>			
c . . . . .	<b>43c</b>			
d . . . . .	<b>43d</b>			
e . . . . .	<b>43e</b>			
<b>44</b> Total functional expenses (add lines 22 through 43). Organizations completing columns (B)-(D), carry these totals to lines 13-15 . . . . .	<b>44</b>			

**Joint Costs.** Check  if you are following SOP 98-2.  
 Are any joint costs from a combined educational campaign and fundraising solicitation reported in (B) Program services?  Yes  No  
 If "Yes," enter (i) the aggregate amount of these joint costs \$ \_\_\_\_\_; (ii) the amount allocated to Program services \$ \_\_\_\_\_; (iii) the amount allocated to Management and general \$ \_\_\_\_\_; and (iv) the amount allocated to Fundraising \$ \_\_\_\_\_

**Part III Statement of Program Service Accomplishments** (See page 25 of the instructions.)

What is the organization's primary exempt purpose? ▶	Program Service Expenses <small>(Required for 501(c)(3) and (4) orgs., and 4947(a)(1) trusts; but optional for others.)</small>
a . . . . . . . . . . . . . . . (Grants and allocations \$ _____ )	
b . . . . . . . . . . . . . . . (Grants and allocations \$ _____ )	
c . . . . . . . . . . . . . . . (Grants and allocations \$ _____ )	
d . . . . . . . . . . . . . . . (Grants and allocations \$ _____ )	
e Other program services (attach schedule) (Grants and allocations \$ _____ )	
<b>f Total of Program Service Expenses</b> (should equal line 44, column (B), Program services) . . . . . ▶	

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**Part IV Balance Sheets** (See page 25 of the instructions.)

		(A) Beginning of year	(B) End of year
<b>Note:</b> Where required, attached schedules and amounts within the description column should be for end-of-year amounts only.			
<b>Assets</b>	45	Cash—non-interest-bearing . . . . .	45
	46	Savings and temporary cash investments . . . . .	46
	47a	Accounts receivable . . . . .	47a
	b	Less: allowance for doubtful accounts . . . . .	47b
			47c
	48a	Pledges receivable . . . . .	48a
	b	Less: allowance for doubtful accounts . . . . .	48b
			48c
	49	Grants receivable . . . . .	49
	50	Receivables from officers, directors, trustees, and key employees (attach schedule) . . . . .	50
	51a	Other notes and loans receivable (attach schedule) . . . . .	51a
	b	Less: allowance for doubtful accounts . . . . .	51b
			51c
	52	Inventories for sale or use . . . . .	52
	53	Prepaid expenses and deferred charges . . . . .	53
	54	Investments—securities (attach schedule) . . . . . <input type="checkbox"/> Cost <input type="checkbox"/> FMV	54
	55a	Investments—land, buildings, and equipment: basis . . . . .	55a
	b	Less: accumulated depreciation (attach schedule) . . . . .	55b
		55c	
56	Investments—other (attach schedule) . . . . .	56	
57a	Land, buildings, and equipment: basis . . . . .	57a	
b	Less: accumulated depreciation (attach schedule) . . . . .	57b	
		57c	
58	Other assets (describe ► _____ )	58	
59	<b>Total assets</b> (add lines 45 through 58) (must equal line 74) . . . . .	59	
<b>Liabilities</b>	60	Accounts payable and accrued expenses . . . . .	60
	61	Grants payable . . . . .	61
	62	Deferred revenue . . . . .	62
	63	Loans from officers, directors, trustees, and key employees (attach schedule) . . . . .	63
	64a	Tax-exempt bond liabilities (attach schedule) . . . . .	64a
	b	Mortgages and other notes payable (attach schedule) . . . . .	64b
	65	Other liabilities (describe ► _____ )	65
66	<b>Total liabilities</b> (add lines 60 through 65) . . . . .	66	
<b>Net Assets or Fund Balances</b>	Organizations that follow SFAS 117, check here <input type="checkbox"/> and complete lines 67 through 69 and lines 73 and 74.		
	67	Unrestricted . . . . .	67
	68	Temporarily restricted . . . . .	68
	69	Permanently restricted . . . . .	69
	Organizations that do not follow SFAS 117, check here <input type="checkbox"/> and complete lines 70 through 74.		
	70	Capital stock, trust principal, or current funds . . . . .	70
	71	Paid-in or capital surplus, or land, building, and equipment fund . . . . .	71
	72	Retained earnings, endowment, accumulated income, or other funds . . . . .	72
	73	<b>Total net assets or fund balances</b> (add lines 67 through 69 or lines 70 through 72; column (A) must equal line 19; column (B) must equal line 21) . . . . .	73
	74	<b>Total liabilities and net assets / fund balances</b> (add lines 66 and 73)	74

Form 990 is available for public inspection and, for some people, serves as the primary or sole source of information about a particular organization. How the public perceives an organization in such cases may be determined by the information presented on its return. Therefore, please make sure the return is complete and accurate and fully describes, in Part III, the organization's programs and accomplishments.



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**Part VI Other Information** (See page 28 of the instructions.)

		Yes	No
<b>76</b>	Did the organization engage in any activity not previously reported to the IRS? If "Yes," attach a detailed description of each activity.		
<b>77</b>	Were any changes made in the organizing or governing documents but not reported to the IRS? . . . . . If "Yes," attach a conformed copy of the changes.		
<b>78a</b>	Did the organization have unrelated business gross income of \$1,000 or more during the year covered by this return?		
<b>78b</b>	If "Yes," has it filed a tax return on <b>Form 990-T</b> for this year? . . . . .		
<b>79</b>	Was there a liquidation, dissolution, termination, or substantial contraction during the year? If "Yes," attach a statement		
<b>80a</b>	Is the organization related (other than by association with a statewide or nationwide organization) through common membership, governing bodies, trustees, officers, etc., to any other exempt or nonexempt organization? . . . . .		
	<b>b</b> If "Yes," enter the name of the organization ▶ . . . . . . . . . . and check whether it is <input type="checkbox"/> exempt or <input type="checkbox"/> nonexempt.		
<b>81a</b>	Enter direct and indirect political expenditures. See line 81 instructions . . . . . <b>81a</b>		
<b>81b</b>	Did the organization file <b>Form 1120-POL</b> for this year? . . . . .		
<b>82a</b>	Did the organization receive donated services or the use of materials, equipment, or facilities at no charge or at substantially less than fair rental value? . . . . .		
	<b>b</b> If "Yes," you may indicate the value of these items here. Do not include this amount as revenue in Part I or as an expense in Part II. (See instructions in Part III.) . . . . . <b>82b</b>		
<b>83a</b>	Did the organization comply with the public inspection requirements for returns and exemption applications?		
<b>83b</b>	Did the organization comply with the disclosure requirements relating to quid pro quo contributions? . . . . .		
<b>84a</b>	Did the organization solicit any contributions or gifts that were not tax deductible? . . . . .		
	<b>b</b> If "Yes," did the organization include with every solicitation an express statement that such contributions or gifts were not tax deductible? . . . . .		
<b>85</b>	<b>501(c)(4), (5), or (6) organizations.</b> <b>a</b> Were substantially all dues nondeductible by members? . . . . .		
	<b>b</b> Did the organization make only in-house lobbying expenditures of \$2,000 or less? . . . . .		
	If "Yes" was answered to either 85a or 85b, <b>do not</b> complete 85c through 85h below unless the organization received a waiver for proxy tax owed for the prior year.		
	<b>c</b> Dues, assessments, and similar amounts from members. . . . . <b>85c</b>		
	<b>d</b> Section 162(e) lobbying and political expenditures . . . . . <b>85d</b>		
	<b>e</b> Aggregate nondeductible amount of section 6033(e)(1)(A) dues notices . . . . . <b>85e</b>		
	<b>f</b> Taxable amount of lobbying and political expenditures (line 85d less 85e) . . . . . <b>85f</b>		
	<b>g</b> Does the organization elect to pay the section 6033(e) tax on the amount on line 85f? . . . . . <b>85g</b>		
	<b>h</b> If section 6033(e)(1)(A) dues notices were sent, does the organization agree to add the amount on line 85f to its reasonable estimate of dues allocable to nondeductible lobbying and political expenditures for the following tax year? . . . . . <b>85h</b>		
<b>86</b>	<b>501(c)(7) orgs.</b> Enter: <b>a</b> Initiation fees and capital contributions included on line 12. . . . . <b>86a</b>		
	<b>b</b> Gross receipts, included on line 12, for public use of club facilities . . . . . <b>86b</b>		
<b>87</b>	<b>501(c)(12) orgs.</b> Enter: <b>a</b> Gross income from members or shareholders . . . . . <b>87a</b>		
	<b>b</b> Gross income from other sources. (Do not net amounts due or paid to other sources against amounts due or received from them.) . . . . . <b>87b</b>		
<b>88</b>	At any time during the year, did the organization own a 50% or greater interest in a taxable corporation or partnership, or an entity disregarded as separate from the organization under Regulations sections 301.7701-2 and 301.7701-3? If "Yes," complete Part IX . . . . .		
<b>89a</b>	<b>501(c)(3) organizations.</b> Enter: Amount of tax imposed on the organization during the year under: section 4911 ▶ _____; section 4912 ▶ _____; section 4955 ▶ _____		
	<b>b</b> <b>501(c)(3) and 501(c)(4) orgs.</b> Did the organization engage in any section 4958 excess benefit transaction during the year or did it become aware of an excess benefit transaction from a prior year? If "Yes," attach a statement explaining each transaction . . . . . <b>89b</b>		
	<b>c</b> Enter: Amount of tax imposed on the organization managers or disqualified persons during the year under sections 4912, 4955, and 4958 . . . . . ▶ _____		
	<b>d</b> Enter: Amount of tax on line 89c, above, reimbursed by the organization . . . . . ▶ _____		
<b>90a</b>	List the states with which a copy of this return is filed ▶ _____		
	<b>b</b> Number of employees employed in the pay period that includes March 12, 2004 (See instructions.) <b>90b</b>		
<b>91</b>	The books are in care of ▶ _____ Telephone no. ▶ (_____) _____ Located at ▶ _____ ZIP + 4 ▶ _____		
<b>92</b>	Section 4947(a)(1) nonexempt charitable trusts filing Form 990 in lieu of <b>Form 1041</b> —Check here. . . . . ▶ <input type="checkbox"/> and enter the amount of tax-exempt interest received or accrued during the tax year . . . . . ▶ <b>92</b>		

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**Part VII Analysis of Income-Producing Activities** (See page 33 of the instructions.)

**Note:** Enter gross amounts unless otherwise indicated.

	Unrelated business income		Excluded by section 512, 513, or 514		(E) Related or exempt function income
	(A) Business code	(B) Amount	(C) Exclusion code	(D) Amount	
<b>93</b> Program service revenue:					
<b>a</b> _____					
<b>b</b> _____					
<b>c</b> _____					
<b>d</b> _____					
<b>e</b> _____					
<b>f</b> Medicare/Medicaid payments . . . . .					
<b>g</b> Fees and contracts from government agencies					
<b>94</b> Membership dues and assessments . . . . .					
<b>95</b> Interest on savings and temporary cash investments					
<b>96</b> Dividends and interest from securities . . . . .					
<b>97</b> Net rental income or (loss) from real estate:					
<b>a</b> debt-financed property . . . . .					
<b>b</b> not debt-financed property . . . . .					
<b>98</b> Net rental income or (loss) from personal property					
<b>99</b> Other investment income . . . . .					
<b>100</b> Gain or (loss) from sales of assets other than inventory					
<b>101</b> Net income or (loss) from special events . . . . .					
<b>102</b> Gross profit or (loss) from sales of inventory					
<b>103</b> Other revenue: <b>a</b> _____					
<b>b</b> _____					
<b>c</b> _____					
<b>d</b> _____					
<b>e</b> _____					
<b>104</b> Subtotal (add columns (B), (D), and (E)) . . . . .					
<b>105 Total</b> (add line 104, columns (B), (D), and (E)) . . . . . ▶					

**Note:** Line 105 plus line 1d, Part I, should equal the amount on line 12, Part I.

**Part VIII Relationship of Activities to the Accomplishment of Exempt Purposes** (See page 34 of the instructions.)

Line No.	Explain how each activity for which income is reported in column (E) of Part VII contributed importantly to the accomplishment of the organization's exempt purposes (other than by providing funds for such purposes).
▼	

**Part IX Information Regarding Taxable Subsidiaries and Disregarded Entities** (See page 34 of the instructions.)

(A) Name, address, and EIN of corporation, partnership, or disregarded entity	(B) Percentage of ownership interest	(C) Nature of activities	(D) Total income	(E) End-of-year assets
	%			
	%			
	%			
	%			

**Part X Information Regarding Transfers Associated with Personal Benefit Contracts** (See page 34 of the instructions.)

- (a) Did the organization, during the year, receive any funds, directly or indirectly, to pay premiums on a personal benefit contract?  Yes  No
- (b) Did the organization, during the year, pay premiums, directly or indirectly, on a personal benefit contract?  Yes  No
- Note:** If "Yes" to (b), file Form 8870 and Form 4720 (see instructions).

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.

<b>Please Sign Here</b>	Signature of officer _____	Date _____
	Type or print name and title. _____	
<b>Paid Preparer's Use Only</b>	Preparer's signature _____	Date _____
	Firm's name (or yours if self-employed), address, and ZIP + 4 _____	Check if self-employed <input type="checkbox"/> EIN _____ Phone no. _____

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# Form 990 Data

The following tables summarize data reported on the annual Form 990 by tax-exempt entities under section 501(c) of the Internal Revenue Code. The tables cover reported assets, revenues, and expenses overall and, where appropriate, broken out by charities and the rest of the section 501(c) entities (i.e., noncharities).

**Table 1: Form 990 Returns Filed by Section 501(c) Entities, Tax Years 1998-2002**

Tax year	Number of returns filed		
	Charities	Noncharities	All entities
1998	281,228	168,309	449,537
1999	299,204	173,239	472,443
2000	301,612	168,963	470,575
2001	301,359	171,006	472,365
2002	302,464	162,134	464,598

Source: Tabulation of data from IRS's Return Inventory Classification System, 1998-2002.

**Table 2: Assets Reported by Section 501(c) Entities in 2004 Constant Dollars, Tax Years 1998-2002**

Tax year	All entities		Charities		Noncharities	
	Assets (in millions)	Percent change	Assets (in millions)	Percent change	Assets (in millions)	Percent change
1998	\$2,208,676	N/A	\$1,509,209	N/A	\$699,467	N/A
1999	\$2,413,917	9.3%	\$1,664,857	10.3%	\$749,059	7.1%
2000	\$2,474,471	2.5%	\$1,696,064	1.9%	\$778,407	3.9%
2001	\$2,552,606	3.2%	\$1,733,734	2.2%	\$818,872	5.2%
2002	\$2,545,189	-0.3%	\$1,694,435	-2.3%	\$850,754	3.9%

Source: Tabulation of data from IRS's Return Inventory Classification System, 1998-2002.

**Appendix III  
Form 990 Data**

**Table 3: Revenues Reported by Section 501(c) Entities in 2004 Constant Dollars, Tax Years 1998-2002**

Tax year	All entities		Charities		Noncharities	
	Revenues (in millions)	Percent change	Revenues (in millions)	Percent change	Revenues (in millions)	Percent change
1998	\$1,121,387	N/A	844,224	N/A	277,163	N/A
1999	\$1,214,807	8.3%	925,849	9.7%	288,958	4.3%
2000	\$1,240,216	2.1%	944,131	2.0%	296,085	2.5%
2001	\$1,258,046	1.4%	953,841	1.0%	304,205	2.7%
2002	\$1,250,914	-0.6%	941,197	-1.3%	309,718	1.8%

Source: Tabulation of data from IRS's Return Inventory Classification System, 1998-2002.

**Table 4: Expenses Reported by Section 501(c) Entities in 2004 Constant Dollars, Tax Years 1998-2002**

Tax year	All entities		Charities		Noncharities	
	Expenses (in millions)	Percent change	Expenses (in millions)	Percent change	Expenses (in millions)	Percent change
1998	\$1,017,582	N/A	\$768,280	N/A	\$249,303	N/A
1999	\$1,091,788	7.3%	\$826,572	7.6%	\$265,215	6.4%
2000	\$1,145,280	4.9%	\$867,063	4.9%	\$278,217	4.9%
2001	\$1,210,670	5.7%	\$912,200	5.2%	\$298,470	7.2%
2002	\$1,221,859	0.9%	\$917,528	0.6%	\$304,330	2.0%

Source: Tabulation of data from IRS's Return Inventory Classification System, 1998-2002.

**Table 5: Section 501(c) Entities' Reported Expenses as a Percentage of U.S. Gross Domestic Product, 1998 -2002**

Year	U.S. GDP (in Millions)	Section 501(c) entities' expenses (in millions)	Section 501(c) entities' expenses as a percentage of U.S GDP
1998	8,747,000	\$1,017,582	11.6%
1999	9,268,000	\$1,091,788	11.8%
2000	9,817,000	\$1,145,280	11.7%
2001	10,128,000	\$1,210,670	12.0%
2002	10,487,000	\$1,221,859	11.7%

Source: Tabulation of data from IRS's Return Inventory Classification System, 1998-2002 and U.S. Department of Commerce figures

# IRS Data on Its Tax-Exempt Oversight

The following tables summarize data provided by IRS on its oversight activities involving tax-exempt entities under section 501(c) of the Internal Revenue Code. The tables cover resources, applications, examinations, and examination results.

**Table 6: Assigned FTEs as IRS Budgeted for Exempt Activities, Fiscal Years 2000-2005**

Fiscal year	Examination FTE	Determination FTE	Other FTE	Total FTE
2000	424	342	32	<b>798</b>
2001	432	347	33	<b>812</b>
2002	421	351	44	<b>816</b>
2003	394	370	38	<b>802</b>
2004	378	348	43	<b>769</b>
2005	467	347	42	<b>856</b>

Source: IRS Exempt Organization officials.

Note: "Other FTE" include technical staff who issue rulings, director's staff, and education and outreach. FTEs assigned are what IRS budgets for this work

**Table 7: Actions Taken on Applications for Tax-Exempt Status, Fiscal Years 1998-2003**

Fiscal year	Total applications	Approved	Percent approved	Denied	Other
1998	78,358	58,162	74.2%	593	19,603
1999	73,605	59,264	80.5%	585	13,756
2000	82,707	67,267	81.3%	482	14,938
2001	81,636	65,409	80.1%	646	15,581
2002	87,342	70,214	80.4%	557	16,571
2003	91,439	72,092	78.8%	1,192	18,155
2004	87,080	69,315	79.6%	1,050	16,715

Source: GAO Analysis of IRS's Exempt Determination System, 1998-2004.

Note: The "Other" category includes applications withdrawn; applications that did not provide the required information; incomplete applications; IRS refusals to rule on applications because the information submitted was insufficient to conclude whether to approve the exemption request; and applications forwarded to other than the IRS National Office.

**Appendix IV**  
**IRS Data on Its Tax-Exempt Oversight**

**Table 8: Examination Rate of Section 501(c) Entities, 1998–2003**

<b>Fiscal year</b>	<b>Returns filed in previous year</b>	<b>Returns examined in fiscal year</b>	<b>Examination rate</b>
1998	458,014	8,290	1.8%
1999	449,537	8,780	2.0%
2000	472,443	6,866	1.5%
2001	470,575	5,471	1.2%
2002	472,365	5,423	1.1%
2003	464,598	5,964	1.3%

Source: GAO Tabulation of IRS's Audit Information Management System and IRS's Return Inventory Classification System, 1997-2002.

**Table 9: Examinations Resulting in No Change to Forms 990 Filed by Section 501(c) Entities, Fiscal Years 1998–2004**

<b>Fiscal Year</b>	<b>Examinations</b>	<b>Examinations resulting in no change</b>	<b>No-change rate</b>
1998	8,290	2,552	30.8%
1999	8,780	3,191	36.3%
2000	6,866	2,431	35.4%
2001	5,471	2,112	38.6%
2002	5,423	2,445	45.1%
2003	5,964	2,965	49.7%
2004	5,889	2,299	39.0%

Source: GAO analysis of IRS's Audit Information Management System, 1998-2004.

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# Tax-Exempt Excise Taxes by Code Sections

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Over the years, Congress has imposed various excise taxes that affect tax-exempt entities, particularly private foundations under Section 501(c)(3). Private foundations differ in several ways from public charities. Public charities have broad public support and tend to provide charitable services directly to beneficiaries. Private foundations are often tightly controlled and receive a significant portion of their funds from a small number of donors, and tend to make grants directly to other entities rather than directly provide charitable services. Since these differences create the potential for self-dealing or abuse by a small group, private foundations are subject to anti-abuse rules not applicable to public charities. In addition, public charities and private foundations generally are prohibited from engaging in certain types of transactions. Excise taxes are to be levied on public charities and private foundations, as well as a few other types of tax-exempt entities, that violate the rules. Details on these rules and excise taxes follow.

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## Section 4940 Excise Tax on Private Foundation Investment Income

Section 4940 was added by the Tax Reform Act of 1969, P.L. 91-172. The related Senate Report<sup>1</sup> described the excise tax as an “audit fee tax” that was believed to be necessary to cover IRS’s costs for increased supervision over private foundations under the act. Section 4940 imposes a 2 percent excise tax on the net investment income of tax-exempt private foundations. Net investment income includes income from interest, dividends, and net capital gains that is reduced by the expenses incurred to earn it. This tax is 1 percent if a private foundation meets certain distribution requirements. Private foundations that meet the requirements to be an “exempt operating foundation” are not subject to this excise tax. Among these requirements are stipulations that the foundation be publicly supported for at least 10 years and that it have a governing body that is broadly representative of the general public. Private foundations that are not exempt from taxation are subject to this excise tax and unrelated business income tax.

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## Section 4941 Excise Tax on Private Foundation Acts of Self-Dealing

Because a tax-exempt entity cannot operate to confer a benefit on private parties, Section 4941 was enacted by the Tax Reform Act of 1969. According to the Senate Report, generally prohibiting self-dealing transactions would minimize the need to apply the subjective arm’s-length standard that was used for loans, payments of compensation, and

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<sup>1</sup>S. Rep. No. 91-552 (1969).

preferential availability of services under the 1950 amendments. Section 4941 imposes a 5 percent excise tax on acts of self-dealing between a private foundation and disqualified persons. This tax is to be paid by the disqualified person who participated in the self-dealing. An additional tax equal to 200 percent of the amount involved is to be imposed if the self-dealing is not corrected during the taxation period. A separate tax equal to 2-½ percent of the amount involved is to be imposed on the foundation's manager if that manager knowingly participated in the act of self-dealing. If this additional tax has been imposed on the foundation manager and that manager refuses to agree to part or all of the correction, an additional tax equal to 50 percent of the amount is to be imposed. Acts of self-dealing include sales, exchanges, or leases of property; lending of money or other extensions of credit; and payment of compensation. Disqualified persons include substantial contributors to the foundation, foundation managers, an owner of more than 20 percent of a business enterprise that is a substantial contributor, and certain government officials.

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**Section 4942 Excise Tax on Private Foundation Failure to Distribute Income**

Section 4942 was enacted by the Tax Reform Act of 1969. Prior to it, a private foundation could lose its exemption if it failed to make distributions towards its charitable purposes instead of just accumulating income. According to the Senate report, the committee believed that loss of exempt status as the only sanction was often ineffective or harsh, and that substantial improvement could be achieved by providing a graduation of sanctions if income is not distributed. Section 4942 imposes a 15 percent excise tax on the undistributed income of a private foundation for any taxable year in which the required amount has not been distributed before the first day of the next taxable year. If an initial tax has been imposed under section 4942 and the income remains undistributed at the end of the taxable period, a tax equal to 100 percent of the remaining undistributed amount is to be imposed. This excise tax does not apply to private operating foundations that meet distribution requirements or to the extent that the failure to distribute is due solely to an incorrect valuation of assets as long as other requirements are met.

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**Excise Tax on Private Foundation Excess Business Holdings (Section 4943)**

Section 4943 was enacted by the Tax Reform Act of 1969. According to its Senate Report, the use of foundations to maintain control of a business appeared to be increasing, and some who wished to use a foundation's stock holdings to control a business were relatively unconcerned about producing income for charitable purposes. Where the charitable ownership predominated, the business could unfairly compete with

businesses whose owners were required to pay taxes on their business income. The committee concluded that a limit on the extent to which a private foundation may control a business was needed. Section 4943 imposes a 5 percent excise tax on certain excess business holdings of a private foundation. Permitted holdings generally include up to 20 percent of the voting stock of an incorporated business enterprise (reduced by the percentage of the voting stock owned by all disqualified persons). Similar holdings are also permitted in partnerships and other unincorporated enterprises (except sole proprietorships). If the excise tax has been imposed, foundations that fail to make the required divestiture of excess holdings above the permitted amounts are subject to an additional tax equal to 200 percent of the excess holdings. In certain cases, foundations are allowed a 5-year period to dispose of the excess holdings and may receive an additional 5-year extension.

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**Excise Tax on Private Foundation Investments which Jeopardize Charitable Purpose (Section 4944)**

Section 4944 was enacted by the Tax Reform Act of 1969. Under prior law, a private foundation could lose its exemption if it invested in a manner that jeopardized its exempt purpose. In the Senate Report, the committee concluded that limited sanctions were preferable to the loss of exemption. Section 4944 imposes an initial 5 percent excise tax on the amount involved if a private foundation invests in a manner that jeopardizes its exempt purpose (e.g., investing with the purpose of income production or property appreciation). If such a tax is imposed on the foundation, a separate 5 percent excise tax is to be imposed on the foundation manager if that manager knew that making the investment would jeopardize the foundation's exempt purpose. If an initial tax is imposed, an additional tax equal to 25 percent of the amount of the investment is to be imposed on the foundation if the investment is not withdrawn within the taxable period. An additional tax equal to 5 percent of the amount of the investment is to be imposed on the foundation manager if the investment is not withdrawn.

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**Excise Tax on Private Foundation Taxable Expenditures (Section 4945)**

Section 4945 was enacted by the Tax Reform Act of 1969. Under prior law, the only sanction against prohibited political activity by a foundation was loss of exemption. The Senate committee report noted that the standards for determining the permissible level of political activity were so vague as to encourage subjective application of the sanction. As a result, section 4945 was added to clarify the types of impermissible activities and provide more limited sanctions. Section 4945 imposes an initial 10 percent excise tax on each taxable expenditure made by the foundation. An additional 2-½ percent excise tax is to be imposed on the foundation manager if that

manager knowingly participated in the taxable expenditure. Taxable expenditures include amounts paid to carry on propaganda or otherwise influence legislation or the outcome of a public election, or to directly or indirectly carry on a voter registration drive. If the expenditure is not corrected within the taxable period, an additional tax equal to 100 percent of the amount of the expenditure is to be imposed on the foundation and additional tax equal to 50 percent of the amount of the expenditure is to be imposed on the foundation manager.

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**Excise Tax on Section  
501(C) (3) Political  
Expenditures (Section 4955)**

Section 4955 was added by the Revenue Act of 1987, P.L. 100-203. According to the House Report<sup>2</sup> for the act, the committee believed that the excise tax applicable to private foundations for making prohibited political expenditures (section 4945) should also apply to a public charity. Section 4955 imposes an initial 10 percent excise tax on each political expenditure of a section 501(c) (3) organization. An additional 2-½ percent excise tax is imposed on the organization's manager if the manager knew that it was a political expenditure. Political expenditures include any amounts paid or incurred by the organization in any participation or intervention in any political campaign on behalf of any candidate for public office. If an initial tax has been imposed regarding a political expenditure and that expenditure is not corrected, an additional tax equal to 100 percent of the amount is to be imposed on the organization. An additional tax equal to 50 percent of the amount of the expenditure is to be imposed on the organization's manager if that manager refuses to agree to part or all of the correction.

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**Excise Tax on Section  
501(C) (3) and (4) Excess  
Benefit Transactions  
(Section 4958)**

Section 4958 was added in 1996 by the Taxpayer Bill of Rights 2, P.L. 104-168. According to the related House Report,<sup>3</sup> this excise tax was added to ensure that the advantages of tax-exempt status benefit the community and not private individuals. The act provided for this intermediate sanction (i.e., something short of a loss of tax exemption) to be imposed when nonprofit organizations engage in transactions with certain insiders that result in private inurement. Section 4958 imposes an initial tax of 25 percent on each excess benefit transaction entered into between a disqualified person and tax-exempt organizations under sections 501(c)(3)

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<sup>2</sup> H. Rep. No. 100-391 (1987).

<sup>3</sup> H. Rep. No. 104-506 (1996).



and (4). The initial tax is to be paid by this disqualified person, including any person who at any time during the 5-year period ending on the date of the transaction was in a position to exercise substantial influence over the organization, a member of such person's family, and a 35 percent controlled entity. Such an entity exists when a disqualified person owns more than 35 percent of the voting power of a corporation, more than 35 percent of the profit interest of a partnership, or more than 35 percent of the beneficial interest of a trust or estate. If an initial tax is imposed on the disqualified persons, an additional tax of 10 percent is to be imposed on the organization's manager if that manager participated knowing that it was an excess benefit transaction. If the excess benefit transaction is not corrected within the taxable period, a tax equal to 200 percent of the excess benefit transaction will be imposed on the disqualified person. Private foundations are not subject to this excise tax.

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### Abatement of Taxes When Corrective Action Taken (Sections 4961 – 4963)

Sections 4961–4963 provide for abating the various excise taxes described above. Section 4961 stipulates that additional taxes shall not be assessed if corrective action is taken within the applicable correction period. Similarly, it stipulates that if the additional tax is already assessed, it will be abated if corrective action is taken. For example, the additional tax of 200 percent for self-dealing shall not be assessed if corrective action is taken within the applicable period. Section 4962 provides that excise taxes shall not be assessed if the event that gave rise to the excise tax was (1) due to reasonable cause, (2) not due to willful neglect, and (3) corrected within the applicable period. If already assessed under these circumstances, the excise tax shall be abated. Section 4963 sets out the instances in which the abatement provisions apply.

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### Excise Taxes Owed for IRC Violations

IRS did not maintain data on how much excise tax involving tax-exempt entities was ultimately assessed or collected either overall or by the various types of violations. These assessments can result from IRS examinations but IRS's system did not maintain information on these types of assessments. These assessments may also arise from tax-exempt entities "self-assessing" excise taxes by reporting the violations to IRS. IRS did record excise taxes owed for certain types of IRC section violations as reported by tax-exempt entities on Form 4720, *Return of Certain Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code* and on Form 990-PF, *Return of Private Foundation or Section 4947(a) (1) Nonexempt Charitable Trust Treated as a Private Foundation*.

**Appendix V**  
**Tax-Exempt Excise Taxes by Code Sections**

As table 10 shows, tax-exempt entities reported self-assessments of at least \$247 million in 2004 constant dollars each year or about \$1.5 billion in 2004 constant dollars for tax years 2000 through 2003.

**Table 10: Excise Tax Amounts That Tax-exempt Entities Self-Assessed on Forms 4720<sup>a</sup> and 990-PF<sup>b</sup> by Code Section, Tax Years 2000-2003 (2004 Constant Dollars in Thousands)**

Code section	Tax year				Total
	2000	2001	2002	2003	
<b>Taxes on organizations</b>					
Section 4942 –Undistributed income	\$2,196	\$4,608	\$3,802	\$2,421	<b>\$13,027</b>
Section 4943 –Excess business holdings; Section 4944 -- Investments that jeopardize, other <sup>c</sup>	385	178	196	35	<b>794</b>
Section 4945 –Taxable expenditures	1,112	702	408	316	<b>2,538</b>
Section 4955 –Political expenditures	1	4	8	0	<b>13</b>
<b>Subtotal</b>	<b>3,694</b>	<b>5,492</b>	<b>4,414</b>	<b>2,772</b>	<b>16,372</b>
<b>Taxes on individuals</b>					
Section 4941 –Self-dealing	438	665	415	204	<b>1,722</b>
Sections 4944, 4945, 4955, and Section 4958 –Excess benefits	70	46	35	46	<b>197</b>
<b>Subtotal</b>	<b>508</b>	<b>711</b>	<b>450</b>	<b>250</b>	<b>1,919</b>
<b>Tax on net investment income</b>					
Section 4940 –Investment Income	683,767	320,811	242,187	244,627	<b>1,491,392</b>
<b>Total</b>	<b>687,969</b>	<b>327,014</b>	<b>247,051</b>	<b>247,649</b>	<b>1,509,683</b>

Source: GAO analysis of IRS data.

<sup>a</sup>Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code.

<sup>b</sup>Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation.

<sup>c</sup>Includes Section 4911 – Excess Lobbying Expenditures and 4912 – Disqualifying Lobbying Expenditures.

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