

**WRITTEN TESTIMONY OF  
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BEFORE THE  
HOUSE WAYS AND MEANS COMMITTEE  
SUBCOMMITTEE ON OVERSIGHT  
ON EXEMPT ORGANIZATION AUDIT SELECTION PROCESSES AND  
INTERNAL CONTROLS  
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**INTRODUCTION**

Chairman Roskam, Ranking Member Lewis and Members of the Subcommittee, thank you for the opportunity to appear before you today to discuss the report by the Government Accountability Office (GAO) on the criteria the IRS uses to select exempt organizations for audit.

Let me begin by reiterating my belief that the IRS must continue to do everything possible to ensure that all individuals and organizations can be confident that they will be treated fairly in their dealings with this agency. I would note that the GAO's report on the criteria we use to select exempt organizations for audit found no evidence of organizations being selected in an unfair or biased manner. We welcome the GAO's recommendations for improvements in our processes in order to lower still further the risk of partiality entering into the audit selection process. The actions we are taking in response to those recommendations are discussed in greater detail below.

It is critical for the IRS to continually monitor its processes and procedures and determine where improvements are needed, not just in regard to audits and other compliance activities, but throughout agency operations. To enhance these capabilities within the IRS, we have established an agency-wide enterprise risk management program, creating risk management liaisons in each area of our operations and providing for the regular identification and analysis of risks to be mitigated or managed. The risk management program builds from and complements existing internal controls and program management activities across the agency.

We are working to further encourage a culture where employees think of themselves as risk managers and understand they should report any issues or problems that occur. My goal is to have employees understand that the only problems we can't solve are the ones we don't know about. As a corollary to that effort, we continue to encourage the flow of information from front line employees up through the organization as well as out to the front line from senior managers.

Recognizing the need to ensure fairness and impartiality in all of the agency's activities, including the exempt organizations area, in 2013 the new IRS Chief Risk Officer – who had been selected from outside the agency – conducted a review of the audit selection criteria used in more than 350 compliance programs across the Service, to identify any instances where there could be a risk of unfairness embedded in that criteria.

I'm pleased to report that the Chief Risk Officer found no evidence of partiality in those programs, and deemed the risk of unfairness entering into these programs in the future to be low, based on the documentary evidence of business rules, procedures, criteria and internal controls reviewed. The Chief Risk Officer did identify a few instances where internal controls could be tightened in order to further reduce the risk of bias, and IRS business units have responded to all of the points he raised.

## **ENSURING FAIRNESS IN EO COMPLIANCE PROGRAMS**

The IRS has a variety of tools at its disposal to make certain that tax-exempt organizations comply with federal tax law. The responsibility for administering these procedures belongs to the Exempt Organizations (EO) function, which is part of the Tax Exempt and Government Entities (TE/GE) Operating Division.

The types of compliance activities that EO conducts in regard to tax exempt organizations fall into two broad categories: audits and compliance checks.

Audits, or examinations, normally include a review of a taxpayer's books and records to determine tax liability, though audits in the tax-exempt area also look at an organization's qualification for tax-exempt status.

EO also conducts compliance checks, which are reviews to determine whether an organization is adhering to recordkeeping and information reporting requirements. In conducting compliance checks, EO specialists may inquire about an item on a return, ask whether specific reporting requirements have been met, or look to see whether an organization's activities are consistent with its stated tax-exempt purpose.

In regard to audits of exempt organizations, EO designs its compliance activities to address issues that carry the most non-compliance risk. We do that by applying data analytics to the wealth of information we receive from Forms 990, *Return of Organization Exempt from income Tax*, which are filed annually by exempt organizations, as well as information from other sources.

Responsibility for developing potential compliance issues and selecting returns for audit falls to the Compliance Strategy Critical Initiatives (CSCI) group within EO. Once the issues are identified, CSCI works to identify the returns that contain the issues in question. The EO Case Selection and Delivery unit (CS&D)

is responsible for obtaining the necessary returns to satisfy the requirements of the examination program and transferring the returns to the appropriate examination groups that cover the geographic areas where the organizations are located.

In developing issues and selecting returns for audit, EO also receives referrals from the general public and Congress about potential non-compliance by exempt organizations. These referrals are all handled in a standardized manner no matter what the source. EO maintains three referral committees to review referrals and determine whether examination potential exists. One committee handles referrals regarding churches or houses of worship, a second handles referrals regarding political campaign activity potentially in excess of what is allowed by law, and the third handles referrals with regard to public figures, or institutions that are considered high profile. Each committee is composed of three senior EO staff members – all of whom are career civil servants – on a rotating assignment, and the committees all make decisions about examination potential by majority vote. Referrals not falling into any of the above three categories are reviewed by a classifier rather than a committee.

As noted above, the GAO's report found no examples of EO selecting organizations for audit based on criteria or practices that fall short of TE/GE's stated mission of ensuring fairness and integrity. In its report, the GAO acknowledged that EO's reliance on a variety of sources to select returns for examination shows that EO recognizes the importance of having a robust and effective internal control system to maintain impartiality in the return selection process.

The GAO noted that EO has well-documented procedures for numerous examination selection processes, all of which are contained in the Internal Revenue Manual (IRM), which is our primary, official source of instructions to staff throughout the IRS.

At the same time, the GAO also identified areas where EO's system of internal controls for the audit selection process could be improved in order to reduce the hypothetical risk that exists for returns to be selected in an unfair or biased manner. In response to the GAO's recommendations, we are proceeding with a number of actions to tighten these internal controls, including the following:

***Updating the Internal Revenue Manual.*** A critical part of ensuring fairness, integrity and consistency in the audit selection process involves communicating the appropriate procedures to EO employees, which as noted above is accomplished primarily through the IRM. The GAO identified a number of areas where updates to the IRM are needed. In fact, EO is in the second year of a three-year plan to update all 145 IRM sections pertaining to the EO function. New sections are being created as new processes are put into place. For example, we are currently developing IRM sections for the simplified and streamlined

exemption application process and the recently implemented post-determination process.

Specifically related to audits, the EO Examinations office is expected to complete its review and update of 46 of the 62 Examinations IRM sections in Fiscal Year (FY) 2015. The remaining sections are scheduled to be reviewed and updated in FY 2016. EO Examinations is also creating new IRM sections to formalize the guidance on compliance checks and compliance reviews, and to outline the EO Compliance Area classification procedures. It is important to note that, as a practical matter, EO requires adherence to both the IRM and all non-IRM procedure documents that are issued, and the GAO did not identify any evidence of deviation from either source of guidance. Going forward, EO will review and update all pertinent IRM sections on an annual basis.

***Expanded monitoring procedures.*** EO will review its current monitoring procedures to ensure that processes, such as documenting explanations for audit selection decisions and obtaining the necessary sign-offs for those decisions, continue to be followed. The monitoring procedures will be accomplished through operational reviews by the appropriate executives. These reviews will document whether the appropriate documentation for case selection decisions is maintained and if periodic adjustments are needed. To be clear, classifiers review referrals – which could be complaints from members of the public not versed in tax law – to identify those that contain potential violations of the federal tax laws. Further review of referrals that do not identify federal tax issues would be inefficient and out of scope.

***Improved documentation of selection processes.*** EO Examinations is undertaking efforts to ensure that all criteria used to select returns for examination and executive approvals for added or changed criteria will be documented, including changes that occur during a project or in a new phase of a project. Additionally, IRM sections are being written for examination selection procedures, including a process to ensure the criteria and selection decisions are consistently documented.

***Additional training for classifiers.*** EO will provide cross-training to employees who work with various types of referrals, to improve their ability to correctly select returns for audit from referrals that cover a wide variety of subject matter. EO will prioritize training of classifiers working with political activity, high-profile and church referrals.

***Increased tracking and maintenance of closed case files.*** EO will review and, if necessary, clarify its internal processes for monitoring and shipping case files, and will work with the other business divisions to ensure proper coordination with them in regard to the process of requesting, shipping, tracking and storing closed case files.

***Ensuring diversity among referral committee members.*** EO will change the policy that members of the committees that review referrals for audit participate on a voluntary basis. Historically, the referral committees have been staffed by qualified employees who volunteer for this assignment with the expectation of being relieved of the assignment in 12 months. As committee workload has increased, fewer qualified employees have volunteered for this assignment and, as a result, this has extended the service of committee members. In recognition of this dynamic, EO plans to staff the referral committees by collateral assignment and not through the volunteer process. Thus, participation by EO managers will no longer be voluntary, and we will ensure committee members are rotated on a regular basis.

## **MAINTAINING IMPARTIALITY THROUGHOUT THE EO FUNCTION**

The work being done within EO to ensure fairness and impartiality extends beyond the audit process. The IRS is continuing the efforts it began in 2013 to implement broad managerial and operational improvements in the determination process for tax-exempt status. The IRS has implemented all of the recommendations made by the Treasury Inspector General for Tax Administration in its May 2013 report. The Inspector General reviewed our responses to those recommendations, and in March of this year issued a follow-up report, noting that the IRS has taken “significant actions” to address the 2013 recommendations.

These are important steps. We have eliminated the use of inappropriate criteria; we have expedited the processing of section 501(c)(4) applications; we have instituted a quality review process to ensure that unnecessary or improper information requests are not sent to applicants; and the Department of the Treasury and the IRS have begun the process of revising draft guidance to address how to measure social welfare and non-social welfare activities of section 501(c)(4) organizations. Our goal on this last point is to provide guidance that is clear, fair to everyone, and easy to administer.

The changes we have made in response to the Inspector General’s recommendations on exempt organizations also include:

- Establishing a new process for documenting the reasons why applications are chosen for further review during the application process;
- Developing new training and workshops for employees on a number of critical issues, including the difference between issue advocacy and political campaign intervention, and the proper way, under current law, to identify applications that require review of potentially significant political campaign intervention;
- Establishing guidelines for EO specialists on how to process requests for tax-exempt status involving organizations engaging in potentially significant political campaign intervention; and

- Creating a formal, documented process for EO determinations personnel to request assistance from technical experts.

In addition to these actions, the entire leadership chain from the top down to the EO function is new since 2013, starting with the Commissioner of the IRS, the Deputy Commissioner for Services and Enforcement, the Commissioner and Deputy Commissioner of TE/GE, and the Director of the EO function.

One critical area addressed by the new leadership team has been the backlog in pending section 501(c)(4) applications. We have reduced the inventory of section 501(c)(4) applications, including the group of 145 cases in the “priority backlog” – those that were pending for 120 days or more as of May 2013. By July 2, 2015, 140 of those cases, or 97 percent, were closed. Of the closed cases, 107 of them were approved, including 43 organizations that took advantage of a temporary self-certification procedure we offered in summer 2013. Of the remaining 33 closed cases, most were closed without a determination, either because the organization withdrew the application or it failed to respond to our questions. To date, five applications have been denied. The remaining five cases are still open.

## **CONCLUSION**

During my tenure as IRS Commissioner, one of my top priorities has been and continues to be making sure the public understands that anyone – any individual, business or organization – dealing with the IRS will be treated fairly, no matter what their political affiliation, their position on contentious political issues, or whom they supported in the last election.

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

In the exempt organizations area, we will continue to review and improve our efforts to maintain appropriate oversight of, and compliance by, the tax-exempt sector, including our examination case selection internal control system.

Chairman Roskam, Ranking Member Lewis and Members of the Subcommittee, this concludes my statement. I would be happy to take your questions.