

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



Emphasis on Unrelated Business Income Tax Enforcement Should Be Enhanced

February 24, 2021

Reference Number: 2021-30-016

The report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document..

TIGTACommunications@tigta.treas.gov | www.treasury.gov/tigta

Why TIGTA Did This Audit

Organizations described in Internal Revenue Code Section 501(c) are generally exempt from Federal income tax. However, under Internal Revenue Code Section 511, organizations are generally subject to tax on unrelated taxable income. This audit was initiated to review the Tax Exempt and Government Entities (TE/GE) Division's Exempt Organizations (EO) Examination function's efforts to identify and examine organizations with unreported or underreported unrelated business income (UBI) tax.

Impact on Taxpayers

The purpose of the UBI tax is to prevent unfair competition between tax-exempt organizations and taxable for-profit organizations. If exempt organizations are not held accountable for compliance with taxable UBI, then it is unfair to those business taxpayers that do report and pay their tax.

What TIGTA Found

During Fiscal Years (FY) 2016 through 2019, the TE/GE Division EO Examination function worked taxpayer refund claims for amended Forms 990-T, *Exempt Organization Business Income Tax Return*, that resulted in refunds exceeding \$90 million. Form 990-T non-refund claim examinations worked by EO during this period resulted in proposed assessments of approximately \$19 million. Above certain refund claim thresholds, TE/GE Division procedures require that an examination be conducted to determine if the refund is warranted. The TE/GE Division asserts that one of the reasons it focuses examination resources on refund claims is that filing a return showing a refund due entitles the taxpayer to interest on the amount of the refund if it is not paid within 45 days. While claim and non-claim examinations are two different types of casework, they both represent the results of Form 990-T (UBI-related) examinations selected and worked by the EO Examination function.

TIGTA reviewed a statistical sample of 141 Form 990, *Return of Organization Exempt From Income Tax*, return examinations completed during FYs 2016 through 2018, in which a Form 990-T was not filed. In 24 examinations, there was no evidence that examiners attempted to identify UBI. When projected to the population, TIGTA estimates there are potentially 227 cases with no evidence that UBI was considered during the examination. In seven examinations, examiners did not attempt to secure Forms 990-T when organizations failed to satisfy their UBI filing requirement for gross income. When projected to the population, TIGTA estimates there are potentially 67 cases in which examiners did not attempt to secure missing Form 990-T returns.

TIGTA reviewed the EO Examination function's procedures and found that the IRS removed sections of the Internal Revenue Manual that emphasized the importance of UBI issues. IRS management stated they removed the statements to be consistent with other revised Internal Revenue Manual sections and Policy Statement 4-119, *Selection and Examination of Returns*. TIGTA is concerned these revisions may cause examiners to believe they are not required to pursue UBI during examinations of exempt organizations.

TIGTA also reviewed a sample of 85 Form 990-T closed examination cases and found that in 10 cases involving net operating loss claims, the classifiers did not make reasonable attempts to verify the net operating loss deduction amount.

What TIGTA Recommended

TIGTA made eight recommendations to help improve guidance, address compliance issues, and safeguard against reporting material errors related to UBI. The IRS agreed with six of the eight recommendations, and some of its plans include: informing taxpayers, in appropriate cases, of potential risks with not complying with their UBI filing requirements; evaluating claim thresholds sent to the field; updating its review procedures for net operating loss claims; and exploring opportunities to improve the accuracy of UBI examination results information reporting.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

U.S. DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

February 24, 2021

MEMORANDUM FOR: COMMISSIONER OF INTERNAL REVENUE

A handwritten signature in blue ink that reads "Michael E. McKenney".

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Emphasis on Unrelated Business Income Tax
Enforcement Should Be Enhanced (Audit # 201930025)

This report presents the results of our review of the Tax Exempt and Government Entities Division's Exempt Organizations Examination function's efforts to identify and examine organizations with unreported or underreported unrelated business income tax. This review is part of our Fiscal Year 2021 Annual Audit Plan and addresses the major management and performance challenge of *Improving Tax Reporting and Payment Compliance*.

Management's complete response to the draft report is included as Appendix II.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).

Table of Contents

<u>Background</u>	Page 1
<u>Results of Review</u>	Page 4
<u>Exempt Organizations Examiners Do Not Always Attempt to Identify Taxpayers With Unrelated Business Income Requirements</u>	Page 4
<u>Recommendations 1 through 3:</u>	Page 12
<u>Recommendations 4 and 5:</u>	Page 13
<u>Classifiers Are Accepting Net Operating Loss Carrybacks Without Consulting an Expert or Reviewing the Source Year</u>	Page 13
<u>Recommendation 6:</u>	Page 15
<u>Management Did Not Always Monitor Form 990-T Examination Assessments, and Examiners Did Not Always Properly Report Unagreed Examination Assessments</u>	Page 15
<u>Recommendation 7:</u>	Page 17
<u>Recommendation 8:</u>	Page 18
Appendices	
<u>Appendix I – Detailed Objective, Scope, and Methodology</u>	Page 19
<u>Appendix II – Management’s Response to the Draft Report</u>	Page 22
<u>Appendix III – Glossary of Terms</u>	Page 28
<u>Appendix IV – Abbreviations</u>	Page 29

Background

Organizations described in Internal Revenue Code (I.R.C.) Section (§) 501(c) are generally exempt from Federal income tax. Generally, to be recognized as exempt from Federal income taxation, the I.R.C. requires organizations to apply for formal exemption recognition and/or to file Form 990s. According to Internal Revenue Service (IRS) management, the IRS currently makes a determination on 28 entity types that an organization can select when applying for tax-exempt status.¹ Under certain circumstances, exempt organizations may be required to pay tax on unrelated business income (UBI). Under I.R.C. § 511, organizations are generally subject to tax on unrelated business taxable income (as defined in I.R.C. § 512).² The UBI tax was intended to prevent unfair competition between tax-exempt organizations and taxable for-profit organizations. In Fiscal Year (FY) 2019, the IRS's gross collections included approximately \$1.2 billion from UBI taxes.³

In Fiscal Year 2019, the IRS's gross collections included approximately \$1.2 billion from UBI taxes.

Unrelated business taxable income is the gross income derived from any unrelated trade or business regularly conducted by the exempt organization, less the deductions directly connected with carrying on the trade or business.⁴ For most exempt organizations, an activity is an unrelated trade or business and subject to UBI tax if it meets three requirements:⁵

- 1) It is a trade or business.
- 2) It is regularly carried on.
- 3) It is not substantially related to furthering the exempt purpose of the organization.⁶

The term trade or business generally includes any activity carried on for the production of income from selling goods or performing services.⁷ Treasury Regulation § 1.513-1(c) ordinarily considers business activities of an exempt organization regularly carried on if they show a frequency and continuity, and if they are pursued in a manner similar to comparable commercial activities of nonexempt organizations. To determine if a business activity is substantially related

¹ The IRS will make a determination whether to recognize exempt status under I.R.C. §§ 501(c), 521, and 501(d). Organizations may also be exempt under I.R.C. §§ 501(c)(1) and 501(c)(24), but the IRS will not issue determinations on these sections.

² There are statutory exclusions from UBI tax including: Investment Income Exclusion - I.R.C. § 512(b)(1); Royalty Exclusion - I.R.C. § 512(b)(2); Rental Income Exclusion - I.R.C. § 512(b)(3); and Gain or Loss from the Sale or Exchange of Property Exclusion - I.R.C. § 512(b)(5).

³ IRS Data Books 2019, Table 1 defines gross collections as collections including penalties and interest in addition to taxes.

⁴ I.R.C. § 512(a)(1).

⁵ Specific exceptions from UBI tax include: volunteer labor – I.R.C. § 513(a)(1), Treas. Reg. § 1.513-1(e)(1); convenience of members – I.R.C. § 513(a)(2), Treas. Reg. § 1.513-1(e)(2); selling donated merchandise – I.R.C. § 513(a)(3), Treas. Reg. § 1.513-1(e)(3); qualified convention and trade show activities – I.R.C. § 513(d)(3), Treas. Reg. § 1.513-3; and specific services provided by cooperative hospital service organizations – I.R.C. § 513(e), Treas. Reg. § 1.513.6.

⁶ Treas. Reg. § 1.513-1(a).

⁷ Treas. Reg. § 1.513-1(b).

requires examining the relationship between the activities that generate income and the accomplishment of the organization's exempt purpose.⁸

A tax-exempt organization must file an annual information return or notice with the IRS, unless an exception applies.⁹ Annual information returns include Form 990, *Return of Organization Exempt From Income Tax*; Form 990-EZ, *Short Form Return of Organization Exempt From Income Tax*; and Form 990-PF, *Return of Private Foundation*. The Form 990-series information returns are the IRS's primary tool for gathering information about tax-exempt organizations. If an exempt organization has \$1,000 or more of gross income from an unrelated business, subject to UBI tax, then it must also file Form 990-T, *Exempt Organization Business Income Tax Return*, to report and pay the UBI tax. Such an organization must file Form 990-T, even if it would not otherwise be required to file a Form 990-series information return.¹⁰

As with other taxpayers, exempt organizations are subject to examinations. The Tax Exempt and Government Entities (TE/GE) Division was established to improve the IRS's ability to meet the special needs of pension plans, tax-exempt organizations, and government entities in complying with the tax laws. The TE/GE Division's mission is to provide customers top quality service by helping them understand and comply with applicable tax laws and to protect the public interest by applying the tax law with integrity and fairness to all. The TE/GE Division has three major functions: Exempt Organizations (EO), Employee Plans, and Government Entities. The EO function ensures that religious, charitable, educational, and other organizations meet and maintain compliance with the complex requirements for tax-exempt status. The TE/GE Division's EO function, which is the subject of this audit, is responsible for conducting UBI-related examinations on exempt organizations.¹¹

The TE/GE Division uses various sources to identify exempt organizations for examination, which are classified under three main groups: 1) Data Driven Portfolio, 2) Referrals and Other Casework Portfolio, and 3) Compliance Strategies Portfolio.¹² The Data Driven Portfolio uses analytical models and queries based on quantitative criteria to identify examinations. The Referrals and Other Casework Portfolio does not entirely rely on data for examination selection, and includes taxpayer-initiated claims requesting tax refunds. The Compliance Strategies Portfolio consists of employee-submitted compliance issues approved by a TE/GE Division governance board, in which returns are selected using sampling or other uses of data to ensure focus on the highest known priority and emerging risks, *i.e.*, referred to as compliance projects.

There are three main internal processing components of the EO function's examination of an exempt organization. Figure 1 illustrates these components as a series of steps in a consolidated examination process.

⁸ Treas. Reg. § 1.513-1(d).

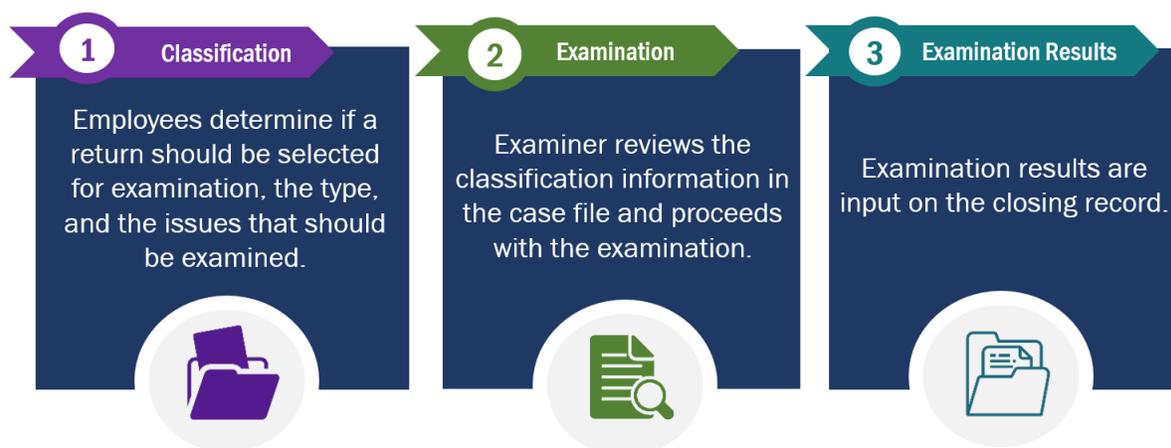
⁹ I.R.C. § 6033(a).

¹⁰ Treas. Reg. § 1.6012-2(e).

¹¹ In November 2019, the organization's realignment moved the GE functions within TE/GE into EO forming "Exempt Organizations and Government Entities" (EO/GE).

¹² Government Accountability Office, GAO-20-454, *Tax Exempt Organizations: IRS Increasingly Uses Data in Examination Selection, but Could Further Improve Selection Processes* (June 16, 2020).

Figure 1: EO Examination Process¹³



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of process for EO function examinations.

A principal objective of the EO Examination function is to select cases that will have the highest positive impact on voluntary compliance and tax administration in an unbiased manner. The Classification and Case Assignment group within the Compliance Planning and Classification office of the TE/GE Division is responsible for classifying cases, *i.e.*, the first step illustrated in Figure 1.¹⁴ This process serves as an internal control to ensure that a separation of duties is maintained between the employee responsible for examining a case and the classification personnel responsible for the selection of that case, which prevents personal influence over the initiation of compliance activities. After the classifiers have completed their work, they transfer the case files to the appropriate virtual shelf. Functional assignment coordinators then review the virtual shelf inventory to fulfill work orders from the EO groups.¹⁵

Group managers then assign cases to their respective examiners, moving the case into the second step, *i.e.*, the examination process. Once assigned, an examiner reviews the classification information in the case file and proceeds with his or her examination. The third and final step of the examination process includes the case close-out procedures and inputting of the examination results. To document the close of the examination, the examiner inputs the results of the examination into the closing record, which subsequently updates TE/GE Division systems. If the exempt organization disagrees with the examiner's decision, the exempt organization can request an appeal to the IRS Independent Office of Appeals (hereafter referred to as the Office of Appeals). The Office of Appeals is separate and independent from the IRS Examination and Collection functions and attempts to resolve tax issues without litigation in a fair and impartial manner to both the Government and the taxpayer that will enhance voluntary compliance.

¹³ Figure 1 illustrates UBI examination steps for this review; it does not include all the steps in the examination process.

¹⁴ Internal Revenue Manual 4.70.5.1.4 (Sept. 24, 2018).

¹⁵ A virtual shelf is where available inventory is held to fulfill pending inventory requests from field groups.

Results of Review

Exempt Organizations Examiners Do Not Always Attempt to Identify Taxpayers With Unrelated Business Income Requirements

To determine the effectiveness of the TE/GE Division's efforts in identifying UBI issues during examinations and enforcing compliance, we selected a stratified statistical sample of 141 unique taxpayers from a population of 1,337 Form 990 return examinations completed during FYs 2016 through 2018, in which a Form 990-T was not filed. We analyzed each of the 141 case files for indications of UBI or evidence of examiners efforts to identify UBI. In our collective analysis of cases reviewed, interviews with TE/GE Division management, and TE/GE Division quality review measures, we found that examiners do not always attempt to identify UBI during focused examinations when UBI is not a pre-identified issue, and examiners do not always require exempt organizations to file a Form 990-T to report UBI when it is identified.

Examinations of exempt organizations include a review of the purposes, activities, and legal structures of such organizations. As previously stated, the IRS makes determinations on 28 entity types that an organization may select when applying for tax-exempt status. Most exempt organizations could potentially generate UBI. To help determine the types of exempt organizations with a significant probability of generating UBI, we reviewed UBI court cases, news articles, and EO examiner desk guides. We also interviewed EO examiners and completed a high gross-receipt analysis on closed Form 990 cases. Based on this analysis, we selected the following six organization types to review:

1. Private Foundations, I.R.C. § 501(c)(3).
2. Private Schools, I.R.C. § 501(c)(3).
3. Hospitals/Other Health Services, I.R.C. § 501(c)(3).
4. Business Leagues, I.R.C. § 501(c)(6).
5. Pleasure, Recreational, or Social Clubs, I.R.C. § 501(c)(7).¹⁶
6. Fraternal Beneficiary Associations and Lodges, I.R.C. § 501(c)(8) and I.R.C. § 501(c)(10).

Examiners do not always attempt to identify UBI during focused examinations when UBI is not a pre-identified issue

During our case reviews, TIGTA identified 24 of 141 examinations in which the examiner did not attempt to identify UBI. The case files provided no evidence of the respective examiner's efforts to identify UBI. When projected to the population of 1,337 cases, we estimate there are potentially 227 cases with no evidence to support the examiner looked for UBI during an examination.¹⁷

¹⁶ I.R.C. § 501(c)(7) organizations are subject to special rules related to unrelated business taxable income under I.R.C. § 512(a)(3).

¹⁷ Our sample was selected using a 95 percent confidence interval, 50 percent error rate, and a ± 8 percent precision factor. When projecting the results of our statistical sample, we are 95 percent confident that the actual total amount is between 157 and 297 exempt organizations (where 157 and 297 represent the lower and upper range, respectively).

The procedures outlined in Internal Revenue Manual (IRM) Chapter 4.75, *Exempt Organizations Examination Procedures*, are essential to understanding the importance of UBI and set the tone for IRS employees. These EO procedures include references that emphasize examiners' efforts to identify UBI. For example, IRM 4.75.10 states that one of the primary objectives of EO examinations is to determine if exempt organizations are liable for taxes associated with UBI.¹⁸ Examiners are expected to look for indications of activities that may affect exempt status or tax liability of an exempt organization by reviewing financial records for possible sources of UBI, any expenses associated with UBI, and asking UBI probing questions during examination interviews.

We asked IRS management how examiners identify UBI issues during their examinations. IRS management stated that examiners should look for large, unusual, or questionable (LUQ) items, and that revenue generated from unrelated business activities are always a consideration when analyzing LUQ items. However, IRS management added that while they expect examiners to look for LUQ items, they do not require examiners to document evidence for issues they do not identify, *e.g.*, if UBI is not identified as an LUQ item, it is not documented. Examiners are expected to adequately explain the items that are examined and the LUQ items that are accepted without examination.¹⁹ In addition, IRS management referenced the IRM section that states all examinations are focused examinations unless otherwise noted, as another reason why examiners may not be looking for UBI.²⁰ This IRM section states that a focused examination is limited to one or more issues that have been pre-identified during a return's screening, classification, or selection process and consideration of LUQ items. Examiners should be looking for LUQ items in all examinations, including a review for sources of income that could give rise to UBI tax.²¹ If the examiners limit their review to consider only items related to the pre-identified issues from the classification process, they may unknowingly miss potential UBI-related issues.

In the 24 cases in which there was no evidence the examiner attempted to identify UBI, [REDACTED] 11 were private foundations, and 12 were issue focused, *e.g.*, Affordable Care Act,²² examinations. TE/GE Division management agreed that the examiner should have looked for UBI and documented actions taken [REDACTED]. However, for the remaining 23 cases, they disagreed that these were exceptions, stating that the examiner did not identify indications of a UBI issue and therefore did not document it. TE/GE Division management also commented that private foundations usually do not have UBI.²³ However, we disagree because there are instances in which private foundations are required to report taxable UBI, such as income generated by certain assets that are debt financed and sales from unrelated business activities.²⁴

In addition to the case reviews, we interviewed 12 examiners from the EO Examination function and asked them about the case file procedures related to UBI, such as where in their case files

¹⁸ IRM 4.75.10.4(1) (Nov. 14, 2019).

¹⁹ IRM 4.10.2.3.1(2) (Sept. 9, 2019).

²⁰ IRM 4.75.10.6.7.2 (Aug. 3, 2017).

²¹ IRM 4.75.10.10.2 (Nov. 14, 2019).

²² Pub. L. No. 111-148, 124 Stat. 119 (2010).

²³ A private foundation that has at least \$1,000 in gross income from an unrelated trade or business must file a Form 990-T.

²⁴ Publication 598, *Tax on Unrelated Business Income of Exempt Organizations* (Rev. Feb. 2019), and instructions provided on Form 990-PF (2019).

they document UBI sources when they are found. All 12 examiners stated they would document whether they found UBI during an examination on Form 5773, *EO Workpaper Summary*. However, when we asked whether they would consider looking for UBI in their examinations only eight out of 12 examiners responded that they would look for UBI in all examinations, including focused audits in which UBI was not a pre-identified issue. The remaining four examiners responded that they did not think it was a requirement to look for UBI in every audit.

We also interviewed three EO Examination function managers and asked if Form 5773 is a required case file document. All three managers stated that Form 5773 is a required case file document. However, we found that front-line managers do not always ensure that examiners look for UBI. When we asked if they review each case file for UBI, only one manager stated that each employee's case file would be reviewed to ensure that the examiner looked for UBI. However, Form 5773 has a specific section related to UBI, and IRM instructions for Form 5773 state if an audit subtopic is not applicable enter "not applicable" and briefly explain why it is not applicable.²⁵

Private foundations remain subject to UBI tax regulations and must comply with reporting requirements. Further, all exempt organizations with qualifying UBI events have unique requirements they must follow to properly report UBI. For the 12 focused cases, the IRS further contended that the examinations were specific and focused on whether the exempt organization continued to qualify for exemption status. However, issue-focused examinations follow the same general examination requirements and should consider UBI. Excessive UBI may be a factor in determining continued exemption status eligibility.²⁶ If occurrences of UBI are not properly identified during an examination, there is a risk that an exempt organization may be given an unfair advantage over a taxable for-profit organization.²⁷ Without evidence of UBI considerations in the case file, we cannot determine if the examiner is familiar with UBI procedures or if they attempted to identify UBI during the examination.

IRS management has confirmed that examiners should look for UBI as part of the LUQ item analysis. If examiners do not attempt to identify UBI, the IRS will miss an opportunity to promote taxpayer compliance by making assessments and educating exempt organizations on proper UBI revenue recognition requirements. During FYs 2016 through 2018, the average IRS tax assessment for Form 990-T agreed non-claim examination cases was approximately \$14,784. In addition, if an organization has excessive UBI, it may lose its tax-exempt status.²⁸ IRS management also confirmed this risk in their response to TIGTA outlining the various tax rules, regulations, and guidance they would consider when revoking an exempt organization's exempt status due to excessive UBI. When an organization loses its tax-exempt status, all of its income is potentially subject to tax.

²⁵ IRM 4.75.10.3.5 (6) (Aug. 12, 2014) and IRM 4.75.10.3.4 (6) (Nov 14, 2019).

²⁶ Treas. Reg. § 1.501(c)(3)-1(e)(1).

²⁷ Treas. Reg. § 1.513-1(b).

²⁸ IRM 4.75.13.7.1(4) (Oct. 16, 2019) provides an example where excessive UBI jeopardizes the organization's revocation of its exempt status.

Some references on the importance of UBI were removed from TE/GE Division's examiner and quality review guidance

The EO Examination function procedures for processing of converted income tax returns are contained in IRM 4.75.31, *Exempt Organizations Examination Procedures, Conversion of Returns*. Prior to October 18, 2019, this IRM contained a background section that emphasized the significance of UBI tax issues. Specifically, the Background included the following statement, "*Exemption and foundation status issues continue to take precedent over income tax issues, other than UBIT issues.*"²⁹

IRS management stated that they removed the statement to be consistent with the other revised IRMs and Policy Statement 4-119, *Selection and Examination of Returns*. However, in our review of the revised IRMs, we did not find any IRM sections containing the same emphasis on the importance of UBI tax. IRS management also stated that the IRM we cited is specific to conversion of a nontaxable return to a taxable return; therefore, the IRM does not apply unless the examination involves a revocation case.³⁰ However, because UBI tax may be relevant in considering the revocation of an organization's exempt status, we believe EO Examination's management decision to remove the UBI reference is significant. We also found that IRM 4.75.10, *Exempt Organizations Examination Procedures, EO Pre-Audit Procedures*, previously contained the following statement for focused audits, "*Items affecting exempt status or foundation status will always be considered a significant item.*"³¹ In August 2017, the IRS also revised this section to no longer include such language, which could give the impression that items affecting exempt or foundation status, such as UBI issues, no longer need to be considered.³² Based on our case reviews in which UBI appeared not to be considered in some cases, we are concerned that the revisions to the IRM may cause examiners to believe they are not required to pursue UBI.

In addition to interviewing front-line managers related to their UBI case review process, we also reviewed the Tax Exempt Quality Measurement System (TEQMS) attribute criteria used to evaluate examiners' work performance. The TEQMS is the only quality measurement system within the TE/GE Division's EO function. We reviewed TEQMS attributes to determine if UBI is included as a performance measure. Specifically, we found that, starting in FY 2018, the TEQMS no longer has an attribute to track whether an examiner looked for UBI as a performance measure. Prior to FY 2018, each TE/GE Division business unit used different TEQMS evaluative criteria, which included distinctive performance measures unique to its examination work. The TEQMS attributes prior to FY 2018 for the EO Examination function included an attribute related to UBI. However, TE/GE Division management and employees formed a cross-functional TEQMS team to combine and update the function-specific quality measures into one set of measures for all TE/GE Division business units. Beginning in FY 2018, the IRS removed the attribute related to UBI. TE/GE Division management stated that the issue of UBI is still considered during a TEQMS review because UBI examples are provided in the TE/GE Division TEQMS user guide, but are not specifically included in the TEQMS attributes to be tracked as a performance measure. Because

²⁹ IRM 4.75.31.1.1 (July 17, 2017). The background section was removed from IRM 4.75.31 effective October 18, 2019.

³⁰ A revocation case means revocation of a ruling or determination letter granting tax-exempt status because an organization failed to meet the statutory requirements for continued recognition of tax-exempt status.

³¹ IRM 4.75.10.6.6.1 (Aug. 12, 2014).

³² IRM 4.75.10.6.7.2 (Aug. 3, 2017).

the attribute related to UBI is excluded from the TEQMS review process, examiners and their managers may believe that TE/GE Division leadership no longer views the pursuit of UBI as important to the overall quality of the exempt entity examinations.

Examiners do not always require exempt organizations to file a Form 990-T when UBI is identified

Treasury Regulation § 1.6012-2(e) establishes the amount of UBI that triggers a filing requirement. If an exempt organization has \$1,000 or more of gross income from an unrelated business, then it must file Form 990-T. In addition, the 2019 Instructions for Form 990-T instruct the exempt organization to input the amount of UBI on Form 990-T.

We used the same statistical sample of 141 unique exempt organizations with completed Form 990 return examinations during FYs 2016 through 2018 to determine whether examiners secured a Form 990-T during the examination when they identified the exempt organization as having gross UBI of \$1,000 or more. We found seven instances out of 141 cases reviewed in which the examiner identified gross UBI of \$1,000 or more, but did not attempt to solicit or secure the Form 990-T. In some cases, the examiner issued an advisory notice to the exempt organization advising it to file a Form 990-T in accordance with Treasury Regulation § 1.6012-2(e), but did not secure the delinquent return. When projected to the population of 1,337 cases, we estimate there are potentially 67 cases in which the examiner did not attempt to secure the delinquent return.³³

IRS management agreed with three of the seven exception cases. However, in four of the seven cases, IRS management supported the examiner's decision to not secure the Form 990-T, stating that the taxable effect on the amount of UBI discovered was minimal. In all four cases, however, the examiner did not enforce the Form 990-T filing requirements. An exempt organization must file a Form 990-T based on gross income filing requirements from UBI, not on the tax impact.

We also identified seven additional cases out of 141 cases in which the examiner identified potential UBI, but did not comment on the actual amount of UBI found or document whether the identified UBI issue fell under or exceeded the reporting threshold for the Form 990-T. Therefore, for these seven cases, we cannot determine with any certainty whether the exempt organizations would have had a Form 990-T filing requirement. However, management agreed that in two of these cases, the UBI issue was not fully developed and addressed in the case file.

From Tax Years 2006 through 2012, the IRS conducted a compliance project focused on 358 social clubs. Among the variety of issues found, examiners secured delinquent or related returns, *e.g.*, Forms 990-T, 940, 941, 945, for 30 of the 358 social clubs examined.³⁴ Further, IRS management noted that more than one-third of the cases closed in the project were closed with a written advisory instead of an examination report. IRS management also commented that, "*It may have been more meaningful to the organization if the agent had issued an exam report with this adjustment...It would also have changed the disposition of the case from merely a*

³³ Our sample was selected using a 95 percent confidence interval, 50 percent error rate, and a ±8 percent precision factor. When projecting the results of our statistical sample, we are 95 percent confident that the actual total amount is between 24 and 109 exempt organizations (where 24 and 109 represent the lower and upper range, respectively).

³⁴ Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*; Form 941 *Employer's QUARTERLY Federal Tax Return*; and Form 945 *Annual Return of Withheld Federal Income Tax*.

written advisory to a tax adjustment or a reduction of their NOL."³⁵ In a second compliance project involving investment income from Calendar Years 2006 through 2009, examiners secured delinquent Form 990-T returns for 32 (39 percent) out of the 83 exempt organizations examined.³⁶ Both compliance projects secured delinquent or related returns, such as the Form 990-T.

The Form 990-T is an important tool in the enforcement of UBI compliance because it allows the IRS to also analyze potential UBI issues contained on the Form 990-T during its review of the primary Form 990 return. However, IRS management's support that examiners may bypass the exempt organization's compliance requirement with Treasury Regulation § 1.6012-2(e), when the tax effect is minimal, sets a potential precedent for decreasing compliance. Exempt organizations may be less likely to file a return when the IRS does not enforce filing requirements, especially if the IRS does not pursue the filing requirement during the course of an examination.

Form 990-T tax examination results from approved claim refunds significantly exceed non-claim assessments

We reviewed Form 990-T examinations closed during FYs 2016 through 2019 to analyze the EO examination tax assessments for this period. We found that Form 990-T tax examination results from approved claim refunds significantly exceeded non-claim assessments. We understand that claim and non-claim examinations are two different types of casework; however, both represent the results of selected and worked Form 990-T (UBI-related) examinations in the EO Examination function.

In efforts to isolate the UBI-related examinations, we removed three project codes that TE/GE Division management confirmed were specifically related to non-UBI examinations.³⁷ We identified a population of 2,056 Form 990-T examination cases closed by the EO Examination function during the period reviewed.³⁸ Figure 2 provides a comparison by fiscal year of the results from these closed taxpayer claim and non-claim examinations.

³⁵ TE/GE I.R.C. § 501(c)(7) Requirements Project Code 8291 Compliance Project, February 2015.

³⁶ TE/GE Investment Income – I.R.C. § 501(c)(7) Compliance Project, September 2010.

³⁷ Closed examinations, within our scope, were classified among 43 project codes. TE/GE Division management confirmed three project codes contained only non-UBI examinations: Project Code 8032, *EOCA-CAWR-FUTA*; Project Code 8309, *CAWR Employment Tax Case*; and Project Code 1073, *Small Business Health Care Tax Credit*. The remaining 40 project codes could contain UBI and/or non-UBI examinations.

³⁸ See Appendix I.

Figure 2: Form 990-T Examination Tax Assessments for FYs 2016 Through 2019³⁹

FY	Taxpayer Claim for Refund Examinations			Non-Claims Examinations			Total Results		
	Exams	Hours	Refunds (in millions)	Exams	Hours	Assessments (in millions)	Exams	Hours	Results (in millions)
2016	115	7,922	(\$35.7)	576	18,432	\$6.0	691	26,354	(\$29.7)
2017	78	5,497	(\$15.5)	448	17,703	\$5.5	526	23,200	(\$10.0)
2018	125	8,404	(\$20.7)	336	13,982	\$1.8	461	22,386	(\$18.9)
2019	111	7,166	(\$18.7)	267	13,799	\$6.4	378	20,965	(\$12.3)
Total	429	28,989	(\$90.6)	1,627	63,916	\$19.7	2,056	92,905	(\$70.9)

Source: TIGTA analysis of Form 990-T examination results from the Base-Inventory Master File (DIMF-BIMF) data files and taxpayer Master File accounts based on Integrated Data Retrieval System research.

We found during this period that the EO Examination function issued Form 990-T refunds exceeding the total value of assessments made on non-claim examinations. Our results show that EO examinations of Form 990-T returns resulted in net refunds of approximately \$71 million during FYs 2016 through 2019. While the claims-related examinations during this period represent approximately 21 percent (429 claims-related examinations) of the 2,056 closed examinations, the high-dollar amount of refunds (exceeding \$90 million) significantly exceeds the positive assessments made on non-claim examinations.

Taxpayers may make a claim by filing an amended Form 990-T. Claims are considered high-priority cases, because taxpayers may sue for a refund if action is not taken within six months of the claim filing date.⁴⁰ The TE/GE Division asserts that one of the reasons it focuses examination resources on refund claims is that filing a return showing a refund due entitles the taxpayer to interest on the amount of the refund if it is not paid within 45 days.⁴¹ Above certain refund claim thresholds, TE/GE Division procedures require that an examination be conducted to determine if the refund is warranted.

42

³⁹ Numbers rounded to the nearest hundred thousand.

⁴⁰ I.R.C. § 6532(a)(1).

⁴¹ I.R.C. § 6611(e)(2).

⁴²

[REDACTED]

We further reviewed the 429 closed claim examinations to determine how many of the initial claim amounts requested by taxpayers fell under the [REDACTED]. We found that 192 (approximately 45 percent) of the 429 closed case claim examinations had a claim amount that was under this threshold. The IRS should evaluate its claim referral threshold for sending cases to EO Examination and consider case-specific issues and risk, in an effort to reduce the impact to limited resources in the field. For example, if an organization that previously paid \$50,000 in UBI taxes files a claim for \$50,000, then additional consideration should be given to refer this taxpayer to the field for examination [REDACTED].

[REDACTED] Alternatively, if an organization that previously paid [REDACTED] in UBI taxes files a claim for [REDACTED] and absent any other identified risks, authority should be considered to grant the Classification Group an exception (on a case-by-case basis) to approve such a claim even if it exceeds the [REDACTED].⁴⁴ Considering case-specific risks could save valuable limited resources.

To determine the impact of time spent by examiners who work claims, we performed a comparative analysis against the TE/GE Division's overall labor costs and full-time equivalents for FYs 2016 through 2019. The TE/GE Division could not provide the operating budgets at the EO Examination function level; however, we used the TE/GE Division's labor metrics to determine an average full-time equivalent hourly rate of \$62.46, and found that during FYs 2016 through 2019, approximately \$1.8 million (\$62.46 x 28,989 hours) in labor expense was spent on examinations of claims for refunds on Form 990-T returns.

The TE/GE Division uses various sources and categorizes examinations into three groups, such as Compliance Strategies, during its examination selection process. The IRS's compliance projects previously mentioned have been successful in securing delinquent or related returns, such as the Form 990-T. The IRS provided information on seven compliance projects related to UBI on Form 990-series information returns and Form 990-T issues. Four of the seven had some results on closed examinations, one was rejected, and two are currently in development. However, the IRS has not proposed any new UBI-related compliance projects since September 2018 that could help address overall compliance issues affecting the volume of claim-related examinations.

The IRS should consider results from completed compliance projects related to UBI issues, continue to move forward with unassigned projects, and develop additional projects that focus on UBI compliance. The results could be used to increase overall compliance. Additionally, the IRS should consider evaluating case-specific risk factors before making a decision on whether to refer a case to the field.

⁴³ [REDACTED] Some other factors that would require the claim to be sent to the field are a lack of explanation or documentation, the organization is part of a special project, the complexity of the issues, additional information is needed from the taxpayer, a prior or recent field examination of the same tax period, or there is an issue with the proper application of tax law.

⁴⁴ These examples are hypothetical and are not drawn from any actual taxpayer's case.

The Commissioner, TE/GE Division, should:

Recommendation 1: Clarify the EO Examination function's guidance to require examiners to address UBI and include evidence of its UBI identification efforts in every case file, including focused examinations.

Management's Response: The IRS disagreed with this recommendation stating that it does not generally single out any one issue for universal consideration, and that it would not be a productive use of limited examination resources to document the absence of UBI in every case file in which it is not a pre-identified issue or otherwise identified as an LUQ item.

Office of Audit Comment: As previously mentioned, the IRM states that one of the primary objectives of EO examinations is to determine if exempt organizations are liable for taxes associated with UBI and instructs examiners to review sources of income that could give rise to UBI tax.⁴⁵ Examiners should document a review for the sources of income that could give rise to UBI tax and not limit this essential review to just pre-identified issues identified from the classification process. If occurrences of UBI are not properly identified during an examination, there is a risk that an exempt organization may be given an unfair advantage over a taxable for-profit organization.

Recommendation 2: Restore UBI references to the IRM to reinforce their importance to an organization's exempt status.

Management's Response: The IRS disagreed with this recommendation and stated that IRM revisions that may have removed UBI references do not indicate a change in policy or emphasis, and that the IRM continues to reflect appropriate procedures and identification of potential issues with UBI noncompliance.

Office of Audit Comment: One of the IRM references removed identified UBI tax issues as taking precedent over exemption and foundation status issues as well as income tax issues.⁴⁶ Not restoring UBI references, such as this one, which were removed from the IRM, may be interpreted by examiners to indicate that UBI is not as important as it once was and may cause examiners to believe that they are not required to pursue UBI.

Recommendation 3: Require, in appropriate cases, that examiners request any missing Forms 990-T and inform taxpayers of the potential risks if they do not comply with their filing requirements in accordance with Treasury Regulation § 1.6012-2(e).

Management's Response: The IRS agreed with this recommendation and plans to inform taxpayers, in appropriate cases, of the potential risks if they do not comply with their Treasury Regulation § 1.6012-2(e) filing requirements. Examiners will use their professional discretion around the materiality of the UBI issue to identify appropriate cases and will also be given additional training on securing delinquent returns.

⁴⁵ IRM 4.75.10.4(1) and IRM 4.75.10.10.2 (Nov. 14, 2019).

⁴⁶ IRM 4.75.31.1.1 (July 17, 2017). The background section was removed from IRM 4.75.31 effective October 18, 2019.

Recommendation 4: Evaluate claim thresholds sent to the field in an effort to minimize impact on limited resources and analyze specific case circumstances to prevent unnecessary case referrals to an EO Examination group.

Management's Response: The IRS agreed with this recommendation and plans to evaluate claim thresholds sent to the field.

Recommendation 5: Include UBI tax issues in future compliance projects to identify issues preventing taxpayers from being compliant with their UBI reporting requirements.

Management's Response: The IRS agreed with this recommendation and plans to continue to work on the development of strategies with UBI issues currently in process as well as any future related submissions.

Classifiers Are Accepting Net Operating Loss Carrybacks Without Consulting an Expert or Reviewing the Source Year

We identified a population of 405 Form 990-T examination cases that closed during FYs 2016 through 2018. We selected and reviewed a statistical sample of 85 Form 990-T claims cases and determined that TE/GE Division classifiers did not make reasonable attempts to verify the net operating loss (NOL) deduction amount in 10 of the 85 claims cases reviewed.⁴⁷ The claims totaled \$248,625 in refunds across these 10 cases that may have been prevented if an examination had been conducted.

An NOL may occur for a tax year when a taxpayer reports deductions exceeding the gross income for the same tax year. An NOL source year is the tax year in which an NOL occurs. A taxpayer can use the NOL as a deduction against gross income in another tax year(s). Claims resulting from an NOL related to UBI are filed on a Form 990-T for the purpose of reducing or eliminating UBI tax that would otherwise be owed in another tax year, other than the source year, and may potentially result in a refund to the exempt organization.

I.R.C. § 172 provides that an NOL may be carried back to tax years prior to the source year or carried forward to tax years after the source year as deductions, thereby preserving the economic impact of the loss. Prior to enactment of the Tax Cuts and Jobs Act, taxpayers could generally carryback an NOL from a source year for two years and then carryforward any remaining NOL for 20 years. The Tax Cuts and Jobs Act modified the rules for the NOLs occurring in tax years after December 31, 2017, by generally no longer allowing NOL carrybacks and allowing taxpayers to carry forward the NOLs from the source year indefinitely.⁴⁸ In the case of exempt organizations with more than one unrelated business, the Tax Cuts and Jobs Act also limited the deduction of the NOLs in tax years beginning after Calendar Year 2017 by requiring that any NOL from a source year after Calendar Year 2017 only be allowed against income from the same unrelated trade or business that generated the NOL. Subsequently, the Coronavirus Aid, Relief and Economic Security Act amended I.R.C. § 172(b)(1) to allow the NOLs occurring in tax years beginning after Calendar Year 2017 and before Calendar Year 2021 to be carried back for five years and carried forward indefinitely.⁴⁹ The varied carryback and carryforward rules

⁴⁷ See Appendix I.

⁴⁸ Pub. L. No. 115-97, 131 Stat. 2054 (2017).

⁴⁹ Pub. L. No. 116-136, 134 Stat. 281 (2020).

unique to the NOLs make it challenging for classifiers and examiners to determine which set of NOL rules to follow. Therefore, the nature of NOL deductions is such that a classifier or an examiner cannot validate an NOL deduction without also verifying the NOL.

As previously explained, the Classification Group reviews all claims cases and evaluates cases for referral to the field; *i.e.*, the EO Examination function. During the Classification Group's evaluation, the assigned classifier must determine whether the claim was timely filed and perform a series of reviews, including a review of the original and amended returns, to analyze changes in support of the amended return (claim). If the claim is not accepted as filed, the classifier prepares a statement explaining all concerns showing why the claim is being sent to the field. The Classification Group relies on the *C&CA – CL4 & CA Desk Guide* (hereafter referred to as the Classification Desk Guide) to help it make decisions on claims.⁵⁰ The Classification Desk Guide encourages classifiers to contact an expert on Form 990-T claims.

The Classification Group fully accepted as filed all 10 of the claims based upon an NOL deduction (hereafter referred to as NOL claims) without assigning them to be worked by the EO Examination function. In their response, IRS management stated the Classification Group followed appropriate guidance in accepting the 10 NOL claims as filed. While classifiers are allowed to accept NOL claims as filed that fall under the established threshold, we believe that the 10 NOL claim cases did not have sufficient support in the case file to accept the claims as filed, nor any mention in the case file to show the classifier sought an NOL expert's guidance, which is encouraged in the Classification Desk Guide, prior to allowing the NOL claim in full. Management also stated that all classifiers who work claims (including NOL claims) are experienced classifiers and have the ability to send the claim case to the field if they find an issue, even if the claim is under the [REDACTED]. Management further contends that it is not part of the normal process to ask for an expert's opinion on every NOL claim case, but there is nothing that prevents a classifier from asking an expert. IRS management did agree that when a classifier consults with an expert, they should document the action in the case chronology, but this may not happen in all cases due to human error.

To understand the impact the NOLs have on UBI, we reviewed two compliance projects performed by the EO Examination function. In both compliance projects, the IRS found issues with the NOLs reported by exempt organizations. Specifically:

- The EO Examination function conducted a UBI compliance project during Calendar Years 2010 through 2012 on 100 exempt organizations that reported no tax due for three consecutive years while reporting more than \$100,000 in gross income from UBI each year. The IRS found 41 percent of closed cases required the reduction or removal of an NOL that was being used to reduce UBI.⁵¹
- The EO Examination function conducted a separate UBI compliance project during Calendar Years 2008 through 2013, for which the IRS sent questionnaires to 400 colleges. The IRS selected 34 of the 400 colleges for examination because their questionnaire responses and Form 990 reporting indicated potential noncompliance in the areas of UBI and executive compensation. The IRS found the exempt organizations improperly

⁵⁰ Classification and Case Assignment (C&CA); Case Assignment (CA) Group; Classification Group 4 (CL4).

⁵¹ TE/GE UBI and Form 990-T Compliance Project, September, 2012.

calculated their NOL, could not substantiate the NOL, or the exempt organization lacked a profit motive, which resulted in the disallowance of \$169 million in the NOLs.⁵²

TIGTA also interviewed eight TE/GE Division classifiers to determine their experience with NOL claims and found only five of the eight classifiers had experience with NOL claims. Three of the five classifiers experienced with NOL claims did not feel comfortable surveying/accepting as filed an NOL claim without verifying the NOL. Based on our review of the EO Examination function's UBI compliance projects and TE/GE Division classifier interviews, there is a concern as to whether NOL compliance issues may be overlooked by classifiers when accepting NOL claims as filed, without validating the NOL deduction amounts as would be done when forwarded to be worked by the EO Examination function.

Refund claims, based on the application of an NOL deduction, require a detailed review of return information to ensure that the claims are valid. While the Classification Desk Guide "encourages" classifiers to contact an expert, classifiers should be required to either solicit advice from an expert or document their own expertise in the case file before accepting the claim as filed or referring the claim to be examined. The complexity of the NOLs is further compounded by the potential multiyear impact. IRS management agreed that an experienced classifier should be involved in the review of NOL claims and specified that a senior EO classifier should be involved in reviewing claims involving an NOL prior to accepting the claim as filed.

Recommendation 6: The Commissioner, TE/GE Division, should update the Classification and Case Assignment's Classification Desk Guide to require experienced senior EO classifiers to review claims involving an NOL prior to accepting the claim as filed and document the review in the case file.

Management's Response: The IRS agreed with this recommendation and plans to update its procedures for senior EO classifiers regarding the review of claims involving an NOL.

Management Did Not Always Monitor Form 990-T Examination Assessments, and Examiners Did Not Always Properly Report Unagreed Examination Assessments

We reviewed Form 990-T UBI examinations closed during FYs 2016 through 2019 and related inventory reports to determine whether TE/GE Division management properly monitored UBI-related examinations. We found that Form 990-T examination results were not always monitored by TE/GE Division management, and examination results on appealed cases were not always properly recorded on the closing record by examiners.

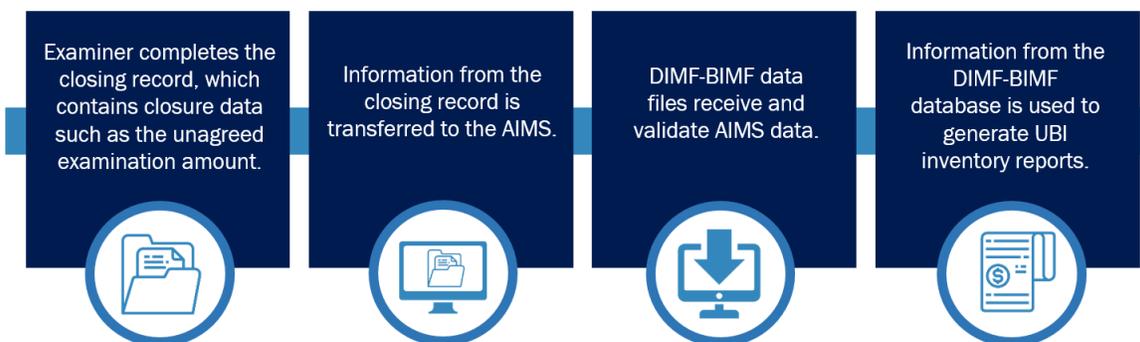
The Audit Information Management System (AIMS) is a computerized system used to secure returns, maintain inventory control of examinations, record examination results, and provide management with the statistical reports required under examination and compliance programs. At the conclusion of an examination, the examiner completes the Form 5599, *TE/GE Examined Closing Record*, which provides examination closure data such as the type of closing, *i.e.*, disposal code, and final examination outcomes such as the proposed tax assessments. The

⁵² TE/GE Colleges and Universities Compliance Project, April 2013.

data on the Form 5599 are loaded into TE/GE Division systems, which create examination inventory reports.

The examiner completes the Form 5599 to close and transfer examination data to the AIMS and into the DIMF-BIMF data files, which receive and validate data related to TE/GE Division activities from the AIMS. The TE/GE Division uses the DIMF-BIMF data files to generate inventory and management reports. Figure 3 illustrates how data from the Form 5599 flow through to the AIMS, then to the DIMF-BIMF data files, and finally to UBI inventory and management reports.

Figure 3: Examination Inventory Reports Creation Process⁵³



Source: TIGTA illustration of the examination inventory reports creation process.

During our initial review of the closed Form 990-T examinations during FYs 2016 through 2018, we found discrepancies with the AIMS examination results amount reported on cases with a taxpayer request to appeal the proposed assessment. The AIMS examination results amount represents the final tax assessment of the examination. We found a discrepancy in the final tax assessment results amount reported in the DIMF-BIMF data files versus the reported amount in the exempt organization's Master File account. We specifically identified the discrepancies with 103 Form 990-T tax return examinations that were appealed by 39 unique exempt organizations.

We shared our results with TE/GE Division management, and they confirmed that there was a discrepancy with the Form 990-T examination results reflected in the AIMS examination results amount. However, TE/GE Division management disagreed with TIGTA's comparison of this amount to the Master File because that comparison would include all adjustments to an exempt organization's Master File account, including those outside the scope of an EO examination, such as subsequent actions by the Office of Appeals or other IRS business operating divisions. To isolate the discrepancy related to the EO examination closing process, the TE/GE Division reviewed the closing record, *i.e.*, Form 5599, against the examination results shown on Form 4549, *Report of Income Tax Examination Changes*, and confirmed an absolute input error of \$17,483,305 across 48 of the 103 Form 990-T tax return examinations that were closed with an appeal during FYs 2016 through 2018.⁵⁴ This discrepancy was further broken down by claim and non-claim examinations:

- \$15,532,497 absolute discrepancy for disputed (appealed) claim examinations.
- \$1,950,808 absolute discrepancy for disputed (appealed) non-claim examinations.

⁵³ The IRS issued interim guidance effective April 23, 2020, to move away from paper Forms 5599 to an electronic closing process.

⁵⁴ The 48 tax return examinations discrepancies were from 22 of the 39 unique organizations identified by TIGTA.

TIGTA agreed with TE/GE Division management's additional review result of the source closing records from respective EO examinations and with the absolute discrepancy of \$17,483,305. Management stated that the discrepancy was due to input errors made by the examiner on the Form 5599 closing record. They further attributed the reason for the inaccurate Form 5599 closing record to inconsistencies with the IRM on inputting the unagreed amount of an examination, particularly in two IRMs that provide alternate instructions on the Form 5599 closing record.⁵⁵ TIGTA also reviewed the two IRMs and confirmed that one IRM directs examiners to input a negative \$1, while the other IRM states that examiners should input the unagreed amount of tax on the closing record. When TIGTA asked TE/GE Division management about their intentions to correct the discrepancy of \$17,483,305, they stated that a closed examination case cannot be altered to reflect accurate closing data.

Prior to FY 2020, TE/GE Division management confirmed that they did not monitor Form 990-T examination tax assessments. However, at the beginning of FY 2020, they amended their EO monthly management reports to include completed Form 990-T activities and examination tax assessments by fiscal year and disposal code. TE/GE Division management also confirmed that the new Form 990-T data on the EO monthly management reports are based on data derived from the Form 5599 examination closing record. Moreover, management stated that Form 990-T total dollars assessed data may be potentially considered in setting up the metrics for UBI compliance strategies.

Examination data from the Form 5599 feeds into AIMS and DIMF-BIMF data files, which are subsequently used to create all inventory and management reports related to Form 990-T examinations. Additionally, other stakeholders that may rely on DIMF-BIMF data files will do so based on potentially compromised data with significant errors. According to TE/GE Division management, they do not use Form 990-T proposed assessment metrics for annual planning. However, this information is now included in monthly EO management reports and may further be considered in developing specific UBI compliance strategies.

After reading a draft of this report, the IRS shared its interim guidance effective April 23, 2020, that obsoleted the need for the examiner to prepare the Form 5599. The information previously captured on the Form 5599 is now captured on the Reporting Compliance Case Management System Closing Record, *i.e.*, in its closing screens. While the closing process is now electronic, the issue we identified remains relevant to prevent material errors that may affect information reports based on the closing process inputs. As such, TE/GE Division management should seek to improve the accuracy of their closing process inputs when closing a case file electronically, so that anyone relying on information contained in available reports, such as the EO management reports, can do so without reservation.

The Commissioner, TE/GE Division, should:

Recommendation 7: Implement safeguards to ensure the accuracy of the Reporting Compliance Case Management System Closing Record to avoid material errors that affect information reports based on these inputs, which are relied upon by internal and external stakeholders.

⁵⁵ IRM 4.5.2.7.1.36 (Sept. 26, 2014) and IRM 4.75.16.4.4.3 (July 18, 2017).

Management's Response: The IRS agreed with this recommendation and plans to explore enhancements to the Reporting Compliance Case Management System as well as training opportunities that will improve the accuracy of inputs resulting in accurate reporting.

Recommendation 8: Replace the respective IRM sections that provide instructions on the Form 5599 with the revised Reporting Compliance Case Management System Closing Record and clarify any differences in how examiners should complete this process for appealed examinations.

Management's Response: The IRS agreed with this recommendation and plans to update and clarify the IRM sections referencing the Form 5599.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to review the TE/GE Division's EO Examination function's efforts to identify and examine organizations with unreported or underreported UBI tax. To accomplish our objective, we:

- Identified and documented general polices, processes, and procedures for EO UBI tax examinations.
- Reviewed various management reports and data used by management to measure program results and interviewed management about how they evaluate program efficiency.
- Reviewed TEQMS criteria to determine performance measures and issues identified related to UBI.
- Reviewed past and planned UBI tax compliance projects to determine if they are a useful tool in identifying UBI tax issues.
- Reviewed Form 990 EO examinations to assess examiners UBI identification efforts.
 - Conducted research, interviewed EO examiners, and analyzed results to identify and profile types of exempt organizations that commonly have UBI tax.
 - Used analysis results to identify a population of 1,337 organizations using the TIGTA's Data Center Warehouse to query the DIMF-BIMF EO data files for Form 990 EO examinations (MFT 67 and 44) with disposition dates (closed) from FYs 2016 through 2018 (October 1, 2015, through September 30, 2018) and further filtered the data by specific activity codes.
 - Selected a stratified statistical sample of 141 organizations from the population of 1,337 for review. TIGTA's contract statistician assisted with developing our sampling plan and projecting the errors to the population. Our sample was selected using a 95 percent confidence interval, 50 percent error rate, and a ± 8 percent precision factor. When projecting the results of our statistical sample, we are 95 percent confident that the actual total amount is between 157 and 297 exempt organizations (where 157 and 297 represent the lower and upper range, respectively).
- Reviewed Form 990-T EO examinations of claims cases to determine the reasons for more refunds and assessments.
 - Identified a population of 405 organizations using the Data Center Warehouse to query the DIMF-BIMF EO data files for Form 990-T (MFT 34) examinations with a disposition date (closed) for FYs 2016 through 2018 (October 1, 2015, through September 30, 2018). To identify the final population of claims cases, we further filtered the data by certain claims related project codes.
 - Selected a statistical sample of 128 organizations from the population of 405 for review. TIGTA's contract statistician assisted with developing our sampling plan and

projecting the errors to the population. Our sample was selected using a 95 percent confidence interval, 50 percent error rate, and a ± 8 percent precision factor.

- Conducted a comparative data analysis on the population of Form 990-T examination claims and non-claims examination results.
 - Used the Data Center Warehouse to query the DIMF-BIMF EO data files for Form 990-T examinations (MFT 34) with a disposition date (closed) for FYs 2016 through 2019 (October 1, 2015, through September 30, 2019) and removed records with certain non-examination group codes and project codes, and identified a population of 2,056 examinations. We confirmed with the Office of Appeals the final determination amounts related to the 117 appealed cases.
 - Conducted a labor analysis on the TE/GE Division Labor Metrics for FYs 2016 through 2019 using data provided by TE/GE Division management.
 - Conducted a data analysis on the population of Form 990-T examinations during FYs 2016 through 2018 to determine the average assessment for agreed non-claim examination cases for FYs 2016 through 2018 (October 1, 2015, through September 30, 2018).

Performance of This Review

This review was performed with information obtained from the TE/GE Division during the period of September 2019 through November 2020. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Major contributors to the report were Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations); Phyllis Heald London, Director; Javier Fernandez, Audit Manager; Beverly Tamanaha, Audit Manager; Jessica Davis, Lead Auditor; and Erik Martinez, Senior Auditor.

Validity and Reliability of Data From Computer-Based Systems

We verified the completeness of the record counts in TIGTA's data extracts against the IRS Data Books for FYs 2016 through 2018. Additionally, we verified the accuracy of 10 returns from each data file against the IRS's Integrated Data Retrieval System and examination documents. We determined that the data were sufficiently reliable for purposes of this report.

Internal Controls Methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: TE/GE Division policies,

Emphasis on Unrelated Business Income Tax Enforcement Should Be Enhanced

procedures, and practices. We evaluated these controls by reviewing appropriate internal procedures and guidelines.

Appendix II

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

February 1, 2021

MEMORANDUM FOR MICHAEL E. MCKINNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Edward T. Killen *Edward T. Killen*
Acting Commissioner,
Tax-Exempt and Government Entities Division (TE/GE)

SUBJECT: Draft Report – Emphasis on Unrelated Business Income Tax
Enforcement Should Be Enhanced (Audit # 201930025)

Thank you for the opportunity to review your draft report titled: “Emphasis on Unrelated Business Income Tax Enforcement Should Be Enhanced.” TE/GE continuously seeks to improve its processes and procedures while maintaining a robust compliance platform to promote compliance by tax-exempt entities with the tax law, including requirements to report and pay any Unrelated Business Income Tax (UBIT).

TE/GE pursues UBIT as a compliance issue in all facets of its compliance program, including two approved compliance strategies focused explicitly on UBIT issues. Compliance strategies are issues submitted by TE/GE employees, developed by a specialized team of analysts, and approved by TE/GE's Compliance Governance Board to identify, prioritize and allocate resources within the TE/GE filing population. TE/GE will continue to evaluate and consider approval of UBIT-related submissions as compliance strategies in the future.

Whether or not UBIT is a pre-identified issue in the case selection process (e.g., a compliance strategy case), TE/GE procedures provide for employees to identify any large, unusual and questionable (LUQ) items and pursue them if present in every examination. To this end, the Internal Revenue Manual (IRM) describing the procedures to follow prior to contacting the taxpayer in an exam provide that agents should “[r]eview ... for ... sources of income that could give rise to UBIT.” See IRM 4.75.10.10.2 (11-14-2019). In some instances, the report questioned the extent of the evidence that the agent considered whether there was UBIT. However, it would not be practical or an efficient use of resources for agents to document every tax law item that is not present as a LUQ in any particular examination. On the other hand, IRS agrees that agents should document where a LUQ is identified and its resolution.

TIGTA expressed an inference about references to UBIT (or lack thereof) in revisions to the IRM. Routinely, the IRS revises the IRM for a number of reasons, including clarity, brevity, and consistency. References to UBIT or any particular provision may be supplanted by the overarching mission “to provide TE/GE customers top quality service by helping them understand and comply with applicable tax laws” in IRM 1.1.23.1. UBIT provisions remain among the tax laws applicable to tax-exempt organizations, whose compliance TE/GE continually enforces. Numerous references to UBIT persist in the IRM such as the one referenced above. Another example is IRM 4.75.12.4.1(1), which indicates that a filing check for Form 990-T, *Exempt Organization Business Income Tax Return*, is always required in an exam. Thus, the IRM remains consistent with the fact that TE/GE continues to undertake and prioritize UBIT compliance, through approved compliance strategies, filing checks, and other enforcement actions.

TIGTA recommends a blanket requirement of Form 990-T filing even when the tax effect is minimal. Yet it is always the case that IRS must balance and prioritize limited resources by utilizing all compliance tools, particularly written advisories. TIGTA’s “one-size fits all” approach would spend resources to secure a Form 990-T in every instance – even where there is not necessarily any net unrelated business taxable income, UBIT, or indication that an organization is undertaking any substantial unrelated business activity in competition with for-profit entities. This could also create additional taxpayer burden without a commensurate benefit. On the other hand, IRS would balance these considerations to promote effective compliance.

TIGTA compares taxpayer-initiated claims for refund with IRS examinations of underreported or unreported UBIT. TE/GE examines all claims over a specified threshold. As observed in another report, “if high-dollar refund claims are not examined, erroneous refund claims might be paid” while “erroneous high-dollar refund claims present a risk to tax compliance.” TIGTA No. 2020-30-023 (June 3, 2020). The report compares claimed refunds allowed with examined tax assessed; however, we believe that *disallowance* would be more comparable to assessment. In any case, IRS undertook four times as many examinations as claim reviews during the specified period (1,627 vs. 429).

We appreciate the opportunity to review and comment on the draft report. Attached is a detailed response to your recommendations. If you have any questions, you or your staff may contact me at (202) 317-8400 or Stephen A. Martin, Acting Director, Exempt Organizations and Government Entities, at (513) 975-6646.

Attachment

**Corrective Actions for TIGTA Audit Draft Report –
Emphasis on Unrelated Business Income Tax Enforcement Should Be Enhanced
(Audit # 201930025)**

RECOMMENDATION 1:

The Commissioner, TE/GE Division, should clarify the EO Examinations' guidance to require examiners to address UBI and include evidence of its UBI identification efforts in every case file, including focused examinations.

CORRECTIVE ACTION:

It would not be a productive use of limited exam resources to document the absence of UBIT in every case file where it is not pre-identified as an issue or otherwise identified as a LUQ item by an agent, thus indicating the risk of UBIT is very low. The TE/GE issue-based examination program generally does not single out any one issue for universal consideration.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL(S):

N/A

CORRECTIVE ACTION MONITORING PLAN:

N/A

RECOMMENDATION 2:

The Commissioner, TE/GE Division, should restore UBI references to the IRM to reinforce their importance to an organization's exempt status.

CORRECTIVE ACTION:

Revisions to the IRM that may have removed references to UBIT do not indicate changes in policy or emphasis. The IRM continues to include numerous references to UBIT reflecting appropriate procedures and the identification of potential issues of non-compliance.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL(S):

N/A

CORRECTIVE ACTION MONITORING PLAN:

N/A

RECOMMENDATION 3:

The Commissioner, TE/GE Division, should require, in appropriate cases, that examiners request any missing Forms 990-T and inform taxpayers of the potential risks if they do not comply with their filing requirements in accordance with Treasury Regulation § 1.6012-2(e).

CORRECTIVE ACTION:

The IRS will inform taxpayers of the potential risks if they do not comply with their filing requirements in accordance with Treasury Regulation § 1.6012-2(e) and in appropriate cases, request any missing Forms 990-T. Appropriate cases will be identified by the examiners exercising their professional discretion around the materiality of the UBI issue. Examiners will be given additional training on securing delinquent returns.

IMPLEMENTATION DATE:

October 15, 2021

RESPONSIBLE OFFICIAL(S):

Director, EO/GE

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 4:

The Commissioner, TE/GE Division, should evaluate claim thresholds sent to the field in an effort to minimize impact on limited resources and analyze specific case circumstances to prevent unnecessary case referrals to an EO Examination group.

CORRECTIVE ACTION:

IRS will evaluate claim thresholds sent to the field.

IMPLEMENTATION DATE:

February 15, 2022

RESPONSIBLE OFFICIAL(S):

Director, CP&C

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 5:

The Commissioner, TE/GE Division, should include UBI tax issues in future compliance projects to identify issues preventing taxpayers from being compliant with their UBI reporting requirements.

CORRECTIVE ACTION:

IRS will continue to work on the development of strategies with UBIT issues currently in process and will develop any future UBIT submissions from employees under its existing procedures.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL(S):

N/A

CORRECTIVE ACTION MONITORING PLAN:

N/A

RECOMMENDATION 6:

The Commissioner, TE/GE Division, should update the Classification and Case Assignment's Classification Desk Guide to require experienced senior EO classifiers to review claims involving an NOL prior to accepting the claim as filed and document the review in the case file.

CORRECTIVE ACTION:

The IRS will update procedures for senior EO classifiers regarding the review of claims involving an NOL.

IMPLEMENTATION DATE:

April 15, 2022

RESPONSIBLE OFFICIAL(S):

Director, CP&C

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 7:

The Commissioner, TE/GE Division, should implement safeguards to ensure the accuracy of the Reporting Compliance Case Management System Closing Record to

avoid material errors that affect information reports based on these inputs, which are relied upon by internal and external stakeholders.

CORRECTIVE ACTION:

The IRS will explore enhancements to RCCMS as well as training opportunities that will improve accuracy of inputs resulting in accurate reporting.

IMPLEMENTATION DATE:

April 15, 2022

RESPONSIBLE OFFICIAL(S):

Director, EO/GE

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 8:

The Commissioner, TE/GE Division, should replace the respective IRM sections that provide instructions on the Form 5599 with the revised Reporting Compliance Case Management System Closing Record and clarify any differences in how examiners should complete this process for appealed examinations.

CORRECTIVE ACTION:

IRS will update and clarify the IRM sections referencing Form 5599.

IMPLEMENTATION DATE:

April 15, 2022

RESPONSIBLE OFFICIAL(S):

Director, EO/GE

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.

Appendix III

Glossary of Terms

Term	Definition
Base-Inventory Master File	A data file that receives and validates data related to TE/GE Division activities from the AIMS.
Classifier	A TE/GE Division EO function employee responsible for reviewing and classifying returns, referrals, and claims cases that are worked by the EO Examination function. A senior classifier also provides guidance to managers, classifiers, and tax examiners on procedures within the Classification function.
Examiner	A TE/GE Division EO Examination function employee who conducts and closes Form 990 and/or Form 990-T examinations.
Fiscal Year	Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.
Full-Time Equivalent	A measure of labor hours in which one full-time equivalent is equal to eight hours multiplied by the number of compensable days in a particular fiscal year.
Integrated Data Retrieval System	IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.
Internal Revenue Code	The Federal tax law, enacted by Congress in Title 26 of the United States Code. It is organized by topics such as income, estate and gift, employment, and miscellaneous excise taxes.
Internal Revenue Manual	The official source of IRS policies, procedures, and guidelines.
Master File	The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
Reporting Compliance Case Management System	An application to support data analytics, querying, and report generating needs of business users for the TE/GE Division.
Tax Exempt and Government Entities Division	IRS operating division that ensures that pension plans, exempt organizations, and government entities comply with the tax laws.
Tax Year	A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.
Treasury Inspector General for Tax Administration's Data Center Warehouse	A collection of IRS data files containing various types of taxpayer account information that is maintained by TIGTA for the purpose of analyzing the data for audits and investigations.

Appendix IV

Abbreviations

AIMS	Audit Information Management System
DIMF-BIMF	Base-Inventory Master File
EO	Exempt Organizations
FY	Fiscal Year
I.R.C.	Internal Revenue Code
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
LUQ	Large, Unusual, or Questionable
NOL	Net Operating Loss
TE/GE	Tax Exempt and Government Entities
TEQMS	Tax Exempt Quality Measurement System
TIGTA	Treasury Inspector General for Tax Administration
UBI	Unrelated Business Income



**To report fraud, waste, or abuse,
call our toll-free hotline at:**

(800) 366-4484

By Web:

www.treasury.gov/tigta/

Or Write:

Treasury Inspector General for Tax Administration

P.O. Box 589

Ben Franklin Station

Washington, D.C. 20044-0589

Information you provide is confidential, and you may remain anonymous.