

**ADVISORY COMMITTEE ON  
TAX EXEMPT AND GOVERNMENT ENTITIES  
(ACT)**

**Exempt Organizations:  
Leveraging Limited IRS Resources in the Tax  
Administration of Small Tax-Exempt Organizations**

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## TABLE OF CONTENTS

<b>I. Executive Summary .....</b>	<b>1</b>
<b>II. Introduction .....</b>	<b>5</b>
<b>III. History .....</b>	<b>7</b>
A. History of EO Reporting Requirements .....	7
1. Background .....	7
2. IRS/State Compact for a Uniform Form 990 .....	7
3. History of the Form 990-EZ.....	8
B. Education and Outreach.....	9
C. Information Sharing with State Charity Regulators .....	11
1. IRS information sharing with state charity regulators under the Tax Reform Act of 1969.....	11
2. Protection of taxpayer information under the Tax Reform Act of 1976 ....	11
3. IRS information sharing with state charity regulators after 2006.....	12
4. IRS efforts to provide disclosure alternatives.....	15
5. IRS sharing of state law violations with state charity regulators under the PPA .....	16
<b>IV. Due Diligence.....</b>	<b>17</b>
A. EO Reporting Requirements .....	17
B. Customer Education and Outreach.....	17
C. Information sharing with state charity regulators .....	18
<b>V. Conclusion.....</b>	<b>21</b>
A. EO Reporting Requirements .....	21
1. Increase the 990-EZ Filing Threshold.....	21
2. Decrease the Form 990-EZ Filing Threshold.....	22
3. Retain the Existing Form 990-EZ Filing Threshold.....	23
4. The ACT's View .....	23
5. Recommendations .....	27
6. Epilogue .....	27
B. Customer Education and Outreach.....	28

1. IRS Website.....	29
2. IRS Academic Institutions Initiative .....	31
3. Prompts for Educational Opportunities .....	32
4. Recommendations.....	33
C. Information Sharing with State Charity Regulators .....	34
1. State Charity Regulator Participation in IRS Information Sharing Under the PPA.....	34
2. Enforcement Referrals by State Charity Regulators to the IRS .....	36
3. Recommendations.....	37
D. Summary of ACT Recommendations .....	38
<b>Appendix A. National Association of Attorneys General Letter to the Senate Finance Committee Urging that Congress Amend the Provisions of Sections 6103, 6104, and 7213 of the Internal Revenue Code .....</b>	<b>41</b>

## I. Executive Summary

In an era of competing and challenging budgetary priorities and constraints, the IRS Exempt Organization Division (IRS) is charged with overseeing and regulating approximately 1.5 million tax-exempt organizations (EOs). These EOs range from the very small, all-volunteer grassroots organizations to very large and sophisticated organizations with thousands of employees and millions or billions of dollars in annual revenues and total assets.<sup>1</sup> For the calendar year 2012, IRS statistics from the Annual Masterfile Extracts indicate there were 294,019 Form 990 filers; 223,348 Form 990-EZ filers; and 98,948 Form 990-PF filers.<sup>2</sup>

This report was written against the backdrop of continuing resolutions and then sequestration with its mandatory cuts rather than an approved congressional budget. This budgetary environment affects the IRS in a myriad of ways. The ACT's report was prompted in part by this budgetary environment and the ACT's desire to suggest ways that the IRS may leverage its resources in regulating EOs, in particular the very small and smaller EOs. Consequently, the ACT attempted to minimize the budgetary impact of its recommendations. However, some of the ACT's recommendations would, if implemented, have a budgetary impact on the IRS. On balance, the ACT believes the benefits to the IRS, state charity regulators, the public, and the nonprofit sector outweigh the fiscal burdens which these recommendations may prompt.<sup>3</sup>

The ACT believes there are two facets to leveraging IRS resources to oversee and provide for the tax administration of these smaller EOs. First, the IRS must determine how best to deploy its internal human, financial, and technological resources over which it has direct management oversight and control. Second, the IRS must consider how to facilitate and encourage external resources over which it may have influence to support and advance the IRS oversight and tax administration of the exempt sector. This ACT report addresses three areas in which the IRS can leverage internal and external resources: (a) the Form 990-EZ filing requirements; (b) IRS customer education and outreach; and (c) IRS information sharing with state charity regulators.<sup>4</sup>

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<sup>1</sup> For purposes of this report, the IRS Tax Advisory Committee for Tax Exempt and Government Entities (ACT) uses the term *very small* to include EOs with annual revenues of less than \$50,000 which meet their annual IRS filing requirement by submitting Form 990-N electronically. The term *smaller* includes EOs with annual revenues of less than \$200,000 and total assets of less than \$500,000 which satisfy their annual IRS filing requirement by filing Form 990-EZ. Large or *larger* organizations have annual revenues and/or total assets in excess of the Form 990-EZ filing threshold and must file IRS Form 990.

<sup>2</sup> This data was derived from the IRS SOI Tax Stats- Annual Extract of Tax-Exempt Organization Financial Data, <http://www.irs.gov/uac/SOI-Tax-Stats-Annual-Extract-of-Tax-Exempt-Organization-Financial-Data> (last accessed April 17, 2013)

<sup>3</sup> The ACT is also mindful that given the current budgetary constraints, it may not be feasible for the IRS to undertake any significant budget initiatives.

<sup>4</sup> These issues are not new to the ACT. The 2005 ACT report included recommendations about filing thresholds (lowering the Form 990-EZ thresholds and reinstating the \$5,000 filing threshold); education and outreach (requiring additional contact information on the Form 1023 and Form 990 including email addresses; expanding FAQs on the EO website; leveraging existing internal and external information outlets to better educate charities regarding ongoing compliance obligations;

The ACT's specific recommendations include the following:

**A. The IRS should require more information from 990-EZ filers without changing the filing thresholds.**

- The IRS should retain the existing filing threshold for Form 990-EZ.<sup>5</sup>
- The IRS should consider the possibility of requiring Form 990-EZ filers to file the following schedules, if applicable:
  - Schedules F (activities outside the United States);
  - I (grants);
  - J (compensation);
  - L Parts III and IV (transactions with interested persons);
  - M (noncash contributions); and
  - R (related organizations).
- The IRS should consider the possibility of adding governance questions to the Form 990-EZ after it has an opportunity to consider the findings of the governance study which will evaluate whether particular governance practices may be useful indicators of tax compliance.

**B. The IRS should enhance its Customer Education and Outreach.**

- The IRS should continue to revise its website and improve its accessibility to individuals engaged in managing smaller EOs. This should include the creation of prominent links beginning with the IRS main web landing page at IRS.gov and the addition of links that visitors can use to report problems and that offer visitors guidance for navigating resources available on the website. The IRS should also encourage state charity regulators and affiliate organizations to create links to the IRS website.

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providing links to information on EO workshops and partnering with umbrella organizations); and sharing more information with the states. *See generally* ACT Report, "Project Improve" ["Informative Materials Prescribe Responsibilities and Obligations Very Early"] – Recommendations to Enhance the Compliance of Newly Formed Charities (June 8, 2005), <http://www.irs.gov/pub/irs-tege/p4344.pdf> (last accessed Mar. 31, 2013).

The 2006 ACT report recommendations included accommodating the reporting needs of the states as long as they do not adversely affect the IRS's primary mission or unduly burden filers; requiring all 501(c) organizations, including organizations below the \$25,000 filing threshold, to complete a Form 990 core form and noting that a core form with schedules may make a Form 990-EZ unnecessary; and removing statutory limits on mandatory electronic filing and phasing in mandatory electronic filing. *See* ACT Report, "Policies and Guidelines for Form 990 Revision" (June 7, 2006), [http://www.irs.gov/pub/irs-tege/tege\\_act\\_rpt5.pdf](http://www.irs.gov/pub/irs-tege/tege_act_rpt5.pdf) (last accessed Mar. 31, 2013).

We gratefully acknowledge the work and recommendations from these earlier ACT members.

<sup>5</sup> Two ACT members disagree and believe the filing threshold should be reduced. *See infra* note 44.

- The IRS should continue to support its Academic Institutions Initiative and other collaborative educational programs and look to build residual capacity in the collaborating entities. The adoption of a “train the trainer” model is an important consideration in this regard.
- The IRS should take additional steps to encourage and facilitate the use of ongoing educational opportunities as an integral component of good board-governance practices. These steps should include adding prompts to checklists that direct consumers to available educational resources for good governance.

**C. The IRS should enhance its information sharing with state charity regulators.**

- The IRS should continue working with state charity regulators to clarify the Pension Protection Act of 2006 strictures on IRS sharing of confidential information and to assist in overcoming obstacles to state PPA participation in IRS information sharing.
- The IRS should encourage increased enforcement referrals from state charity regulators by (a) educating them about IRS enforcement priorities and the processes and criteria the IRS applies for determining appropriate remedies and (b) encouraging them to share information about their IRS referrals with other states.

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## **II. Introduction**

The IRS's tax administration of very small and smaller EOs is particularly challenging for several reasons. The first is the sheer number of such EOs. Recent IRS Statistics of Income studies indicate for the 2010 tax year that more than 69 percent of EOs with IRS filing requirements (about 642,000 organizations) had gross receipts and total assets below the Form 990 filing threshold of gross receipts of \$200,000 or more or total assets of \$500,000 or more.<sup>6</sup> The second is the difficulty in reaching and maintaining contact with these organizations. Many lack a regular place of business and are staffed by volunteers who turn over frequently. The third is their inability to secure competent internal bookkeeping staff or outside tax advisors. This makes them prone to tax mistakes arising from a lack of information about their responsibilities under the tax laws, including basics like how to maintain adequate books and records.

Challenges exist for smaller EOs as well. Some organizations, particularly those run solely by volunteers, may have difficulty preparing and filing even the Form 990-EZ, which is a much simpler form filed by eligible organizations with gross receipts of less than \$200,000 and total assets of less than \$500,000. Having to pay an outside Form 990 return preparer or travel to attend a tax conference may put a serious dent in these organizations' budgets, diverting funds that—in the view of smaller EOs—are far better spent on mission-related activities. Many smaller EOs feel strongly that they are working very hard to “do good” and should not be burdened by what appears to be unnecessary paperwork or expected to take time to attend educational programs. These well-intentioned organizations simply want to be free to do their good work with as little administrative burden as possible.

At the same time, it is clear that not all very small and smaller EOs seek to “do good.” State charity regulators see many EOs created and run by opportunistic individuals who use a charitable mission as a cover for fundraising efforts that at best yield pennies on the dollar to the charity and at worst are a cover for blatantly fraudulent activities. State charity regulators have identified certain “causes” particularly susceptible to this type of abuse. They include so-called *badge organizations*, which solicit funds purportedly on behalf of police or fire organizations and often intimidate people into contributing by fostering a belief that failure to contribute may jeopardize their right to public protection.

The IRS devotes extensive resources to customer education and outreach, but faces substantial challenges when reaching out to very small and smaller EOs. Even though these EOs are exempt from tax, they are subject to many legal requirements imposed by tax laws. Their

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<sup>6</sup> Some EOs, such as churches, do not have IRS filing requirements. Data for tax year 2010 is incomplete since some returns with extensions were not due until 2012 and such data is not included in the totals listed above. Based on available data for tax year 2010, of the 642,000 organizations with gross receipts and total assets below the Form 990 filing threshold, some 236,000 filed Form 990-EZ and some 407,000 filed Form 990-N.

failure to understand and comply with these requirements can place their very existence in jeopardy. There is no more compelling illustration of this than the cumulative revocation of the tax exemption of approximately 40,000 EOs which failed to file IRS Form 990 series returns for three consecutive years following the new filing requirement imposed by the PPA and which subsequently have filed seeking reinstatement of their exempt status.

The PPA included a new Form 990-N filing for organizations whose gross receipts and total assets are below the Form 990-EZ filing threshold and provided for automatic revocation for failure to file Form 990 series returns for three consecutive years. Based on the number of EOs that have applied for reinstatement, it appears that many of the automatic revocations were of EOs no longer in existence, but there was a significant number of currently operational EOs that lost their exemptions as well. The fallout from the Form 990-N automatic revocation adversely impacted these EOs and put a very serious drain on IRS resources.

IRS resources can be leveraged by partnering with state charity regulators, who share oversight of EOs and have many overlapping concerns about the effective use of EO resources in pursuit of their missions. With the PPA, Congress greatly expanded the IRS's authority to share enforcement information with the states. However, only three state charity regulators have taken advantage of information sharing because of PPA limitations on how shared information can be received and used. Further, state enforcement referrals to the IRS have not been as robust as they could be because of differing IRS and state enforcement objectives.

For these reasons it is critical for the IRS to have in place an appropriate and balanced program for the tax administration of smaller EOs which leverages resources external to the IRS as much as possible. In this era of budget cuts, the ACT believes the IRS should take additional appropriate measures to leverage its resources in the tax administration of smaller EOs. This ACT report approaches this topic from three perspectives:

- examining the Form 990-EZ filing thresholds,
- identifying ways to better reach and educate small EOs, and
- exploring options for achieving greater mutual information sharing with state charity regulators.

The discussion below explores and offers recommendations in each of these areas.

### **III. History**

#### **A. History of EO Reporting Requirements**

##### **1. Background**

For tax years 1941 through 1967 most organizations exempt from federal taxation under Section 501(a) filed a Form 990. There was no short-form alternative to Form 990. A one-page Form 990-SF (Short Form) was introduced for the 1968 and 1969 tax years. This form could be completed by EOs with not more than \$10,000 in both gross receipts and total assets. In lieu of completing the full Form 990, these EOs were required to complete only certain lines of Form 990 and could leave the remaining lines blank for tax years 1970 through 1975. In 1976 this threshold was increased to include EOs with not more than \$25,000 in gross receipts.

##### **2. IRS/State Compact for a Uniform Form 990**

In 1980 the IRS formed a subgroup of the Tax Forms Coordinating Committee to initiate and review all IRS forms. This committee included state charity regulators and charitable group representatives to establish a uniform Form 990 that could be used by the federal government and the states in order to keep the Form 990 revisions intact. The subgroup would recommend any future changes to the form. At that time it was estimated by the Urban Institute's National Center for Charitable Statistics that \$100 million to \$125 million was being expended by charities on the preparation of separate federal and state forms. At the urging of the National Association of Attorneys General and the National Association of State Charity Officials, more than half of the 39 states that had filing requirements agreed to use the new Form 990 to satisfy those requirements.

On April 28, 1981, the states and the IRS entered into an agreement that the revised Form 990 would become the basic reporting document for exempt organizations reporting funds from the public.<sup>7</sup> Under this agreement, the subcommittee was to determine what information was essential for disclosure of fiduciary responsibilities and public scrutiny of EOs.<sup>8</sup>

The use of a uniform Form 990 provided extensive savings in data processing costs to the states and accounting costs to the EO community. Accordingly, this cooperative effort in creating a uniform Form 990 greatly enhanced the ability of the IRS and state charity regulators to obtain necessary information on the activities of EOs. Since 1981 Form 990 has been

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<sup>7</sup> This agreement came as a result of a special study commissioned in 1975 by Congress and the Department of Treasury. The Commission on Private Giving and Public Needs is better known as the Filer Commission.

<sup>8</sup> On April 28, 1981, at a public IRS hearing, then Commissioner Roscoe Egger announced the IRS's agreement with substantially all of the states with reporting requirements that a uniform Form 990 had been agreed to. *See* IRS News Letter, Vol. 5, No. 4 (July/August 1981).

accepted by many states in partial satisfaction of state filing requirements, and subsequent changes to Form 990 have reflected states' needs as well as federal initiatives.<sup>9</sup>

### **3. History of the Form 990-EZ**

The IRS continued with various modifications of the thresholds and content of Form 990 during the tax years 1976 through 1989. In tax year 1989 Form 990-EZ was first introduced. EOs could file Forms 990-EZ if their annual gross receipts were less than \$100,000 and their total assets were less than \$250,000. EOs generally were exempt from Form 990/990-EZ filing requirements if their annual gross receipts were normally not more than \$25,000. These filing requirements continued through tax year 2007.

In response to public comment that smaller organizations did not have sufficient resources to complete the full Form 990, the IRS redesigned the Form 990 for tax year 2008 to minimize the filing burden for these smaller organizations in two significant ways:

- The IRS established a transition period (2008-2010) during which Form 990-EZ filing thresholds were initially increased (see below) and resulted in more organizations being eligible to file Form 990-EZ;<sup>10</sup> and
- The IRS did not redesign Form 990-EZ or increase reporting by Form 990-EZ filers. Although certain redesigned Form 990 schedules also applied to the Form 990-EZ, the IRS was careful only to require reporting of information that Form 990-EZ filers were required to report prior to the redesign.

The number of EOs voluntarily filing Forms 990 was larger during the phase-in period.<sup>11</sup> This may be because some organizations knew they would have to file Forms 990 at some point. Some organizations may have wished to present the details contained in their Forms 990 to the public, to meet state filing requirements or to satisfy the requirement of funders such as federated fundraising campaigns. During the period for tax years 2008 through 2010 the filing threshold was phased in and reduced from requiring EOs with gross receipts of less than \$1,000,000 and total assets of less than \$2,500,000 to the current filing threshold of

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<sup>9</sup> See "Advisory Committee for Tax Exempt and Government Entities (ACT), *Report of Recommendations*" (June 2006), "Policies and Guidelines for Form 990 Revision," Part IV a., at 8.

<sup>10</sup> Tax year 2008: In lieu of completing full Forms 990, filers could file Forms 990-EZ if their annual gross receipts were less than \$1 million and their total assets were less than \$2,500,000; organizations continued to be exempt from Form 990/990-EZ filing if their annual gross receipts were normally not more than \$25,000.

Tax year 2009: In lieu of completing full Forms 990, filers could file Forms 990-EZ if their annual gross receipts were less than \$500,000 and their total assets were less than \$1,250,000; organizations continued to be exempt from Form 990/990-EZ filing if their annual gross receipts were normally not more than \$25,000.

Tax years 2010 to present: In lieu of completing the full Forms 990, filers can file Forms 990-EZ if their annual gross receipts are less than \$200,000 and their total assets are less than \$500,000. Organizations are exempt from Form 990/990-EZ filing if their annual gross receipts are normally not more than \$50,000, but must file Forms 990-N.

<sup>11</sup> In tax year 2008 53% filed the 990 and tax year 2009 36% filed the 990.

gross receipts of \$200,000 and total assets of \$500,000. For the 2010 tax year, 17 percent of EOs eligible to file Forms 990-EZ nonetheless filed Forms 990.<sup>12</sup>

Currently, only limited financial data is required to be presented in Form 990-EZ. The filing does not contain the same transparency concerning governance and management disclosures as Form 990.

Form 990-EZ contains various triggering questions which determine whether an organization must file one or more of the following Schedules:

- Schedule A – Public Charity Status and Public Support
- Schedule B – Schedule of Contributors
- Schedule C – Political Campaign and Lobbying Activities
- Schedule E – Schools
- Schedule G – Supplemental Information Regarding Fundraising or Gaming (Parts II & III)
- Schedule L – Transactions with Interested Persons (Parts I & II)
- Schedule N – Liquidation, Termination, Dissolution or Significant Disposition of Assets
- Schedule O – Supplemental Information

A limited number of EOs whose income and assets are within the Form 990-EZ filing threshold are statutorily prohibited from filing Forms 990-EZ and must file Forms 990. These include a sponsoring organization of donor-advised funds and a controlling organization of one or more controlled entities as described in section 512(b)(13). In addition, an organization is required by Treas. Reg. § 1.6033.2(c) to file a series Form 990, 990-EZ, or 990-N if exempt status has not yet been recognized by the IRS.

## **B. Education and Outreach**

The IRS devotes extensive resources to customer education and outreach. The IRS has developed numerous publications, a website, web-based materials, an EO Update, and videos to provide information for applying for and maintaining tax-exempt status.<sup>13</sup> The IRS collabo-

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<sup>12</sup> Tax year 2010 is the most current year for which the ACT has data.

<sup>13</sup> The IRS Exempt Organization Division's primary web landing page is located at <http://www.irs.gov/Charities-&-Non-Profits> (last accessed Mar. 23, 2013). As this report was being drafted, this page was improved and modified as part of the continuing upgrades by the IRS Exempt Organization Division's Customer Education and Outreach.

rates with academic institutions to conduct workshops and training programs specifically for small and medium-sized 501(c)(3) EOs.<sup>14</sup>

Yet, the IRS faces substantial challenges in reaching out to the very small and smaller EOs. These organizations are often overseen by volunteers, with high turnover among board members and officers. This turnover creates disruption in terms of knowledge of reporting requirements and often loss of required documentation, e.g., Form 1023 and its related determination letter and Form 990.

The challenge the IRS faces in reaching out to smaller EOs was brought sharply into focus following the enactment of the PPA. Prior to the PPA, EOs with revenue of less than \$25,000 were not required to file any documents with the IRS (other than Forms 990-T and 990-PF and forms such as those pertaining to employment tax) after filing their Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code (Form 1023) and receiving recognition of their exempt status.

The PPA required all EOs to file annual Form 990, Form 990-EZ or Form 990-N (e-postcard) notices. Failure to file a return for three consecutive years resulted in an automatic revocation of the organization's tax-exempt status by law. Because very small EOs with less than \$25,000 in revenue previously had not been required to file annually, the IRS did not have current mailing addresses for EOs in many instances.

Between 2007 and 2010 the IRS engaged in extensive outreach and communications to the exempt sector through multiple means to reach EOs potentially subject to automatic revocation. The IRS mailed information to EOs for which it had valid mailing addresses. It posted information on the IRS website and updates on EO Update. The IRS reached out to the exempt sector through state charity regulators, state and national membership associations, academic institutions, and professional entities such as accounting and law firms. The IRS engaged the general public through the national, state, and local news media, as well as online and print media primarily focused on the exempt sector.

The great majority of EOs fulfilled their filing requirements mandated by the PPA. However, approximately 500,000 organizations failed to file and their exemptions were revoked as required by statute. Many of these organizations are believed to be no longer operating or in existence. The IRS currently simply does not have information to make this determination. To date approximately 40,000 organizations whose exempt statuses were revoked as required by the PPA have submitted Forms 1023 seeking reinstatement of their exempt status.

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<sup>14</sup> See, Academic Institutions Initiative, <http://www.irs.gov/Charities-&-Non-Profits/Academic-Institutions-Initiative-%E2%80%93-Exempt-Organizations-Partners-with-Academic-Institutions-Training-Non-Profit-Sector-Leaders> (last accessed Mar. 23, 2013).

## C. Information Sharing with State Charity Regulators

### 1. IRS information sharing with state charity regulators under the Tax Reform Act of 1969

The specific functions of the IRS and state charity regulators are distinct. The IRS accomplishes its mission through the enforcement of federal tax laws. State charity regulators have common law *parens patriae* oversight over public charities and they apply state nonprofit corporation, consumer protection, trust, and charitable solicitations laws. However, the goals of state and federal regulatory schemes often overlap. Both state and federal regulators have material concerns about ensuring against excess compensation, private inurement, waste, fraud, conflicts of interest, and other abusive practices. They share similar concerns about the efficient and effective use of EOs' resources in pursuit of their missions.

Consistent with these shared concerns, the Tax Reform Act of 1969 added Section 6104(c).<sup>15</sup> This Section required the IRS to disclose final denials and revocations of tax-exempt status and final notices of deficiency regarding Chapter 42 Excise Taxes to state charity regulators and state tax officials. The disclosure provisions were intended to facilitate effective enforcement of state common law and statutory requirements regarding organizations described in Section 501(c)(3) as charities. Consequently, state charity regulators were able to compare IRS disclosures with their existing state case files and ongoing state investigations and to determine if EOs should have notified the states concerning the disposition of EO charitable assets upon termination.

### 2. Protection of taxpayer information under the Tax Reform Act of 1976<sup>16</sup>

Prior to 1977 tax information was considered a public record and open to inspection under Treasury regulations approved by the president or under presidential order. After the Watergate hearings there was increased congressional and public concern about the widespread misuse of tax information by government agencies for purposes unrelated to tax administration. The Privacy Act of 1974 embodied the principle that information collected by the government should only be used for the purpose for which it was collected.<sup>17</sup>

This concern culminated with the enactment of Section 6103 as part of the Tax Reform Act of 1976.<sup>18</sup> Congress sought to end highly publicized attempts to use the IRS for political purposes and to regulate the flow of tax data from the IRS to state governments. Accordingly, Section 6103 eliminated much of the executive discretion concerning the disclosure of returns or return information by mandating that tax returns and return information were confi-

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<sup>15</sup> Pub. L. No. 91-172, 83 Stat. 523 (1969).

<sup>16</sup> This Section about the Tax Reform Act of 1976 borrows heavily from IRS Pub. No. 4639, "Disclosure and Privacy Law Reference Guide," pp. 1-1, and 1-7 through 1-10.

<sup>17</sup> 5 U.S.C. § 552a (1974).

<sup>18</sup> Pub. L. No. 94-455, 90 Stat. 1520 (1976).

dential and not subject to disclosure, except in the limited situations delineated by the Internal Revenue Code.

The Tax Reform Act of 1976 created a comprehensive statutory scheme for the disclosure and use of tax returns and return information. The four basic parts to this statutory scheme are:

- The general rule of Section 6103(a) made tax returns and return information confidential except as expressly authorized in the Code.<sup>19</sup>
- The exceptions to the general rule outlined permissible disclosures.<sup>20</sup>
- Technical, administrative, and physical safeguard provisions prohibited recipients of returns or return information from using or disclosing the information in an unauthorized manner and established accounting, recordkeeping, and reporting requirements to assist in congressional oversight.<sup>21</sup>
- Criminal penalties were imposed, including a felony for the willful, unauthorized disclosure of returns or return information, and a civil cause of action was provided for the taxpayer whose information has been inspected or disclosed in a manner not authorized by Section 6103.<sup>22</sup>

Significantly, Section 6103 did not affect the provisions of Section 6104 providing for IRS disclosure of information about exempt organizations to state charity regulators and state tax officials until 30 years later when Congress amended Section 6104(c) as part of the PPA in 2006.

### **3. IRS information sharing with state charity regulators after 2006**

In 2006 the PPA incorporated the tax return confidentiality provisions of Section 6103 as a prerequisite for substantially expanding the types of information the IRS could share with state charity regulators. State charity officials were permitted to receive both examination and determination information much earlier in the process.<sup>23</sup> Under amended Section 6104(c), the IRS was now authorized to share with state charity regulators:

- information about EOs applying for tax-exempt status under Section 501(c)(3) from the initial application through proposed refusals to grant such status to final approval or denial;

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<sup>19</sup> Definitions of key terms such as return and return information are located in Section 6103(b).

<sup>20</sup> I.R.C. §§ 6103(c)–(o).

<sup>21</sup> *Id.* § 6103(p).

<sup>22</sup> *Id.* §§ 7213 (criminal penalty for unauthorized disclosure) & 7431 (civil damages provision).

<sup>23</sup> Prior to enactment of the PPA, the IRS was only permitted to disclose to state charity regulators information concerning final denials and revocations of tax-exempt status and final notices of deficiencies.



- information about EOs that have been proposed for revocation of exempt status;
- information about EOs for which a proposed Chapter 42 notice of deficiency is issued through the final notice of deficiency or final resolution; and
- proposed and final Chapter 42 notices of deficiency for disqualified persons.

The IRS can share information about certain proposed revocations and proposed denials before an administrative appeal is made and a final revocation or denial issued. The IRS also is authorized to disclose final revocations and final denials issued after any administrative appeal has been concluded for any EO.

The IRS Determination Office in Cincinnati issues monthly reports to state charity regulators who have information sharing agreements. These reports show EOs which have applied for Section 501(c)(3) status within each state and the status of their applications. The IRS can provide participating states with a copy of the application before the IRS takes any action on it. For proposed revocations and notices of deficiency, the IRS prepares a package containing the 30-day letter to the EO and the revenue agent's report, which explains in detail the factual and legal positions of the EO and the IRS.

State charity regulators would welcome receiving information which is available under the PPA and would enhance their oversight of EOs.<sup>24</sup> For example, information now available under Section 6104(c) about EOs receiving a proposed denial of Section 501(c)(3) status immediately raises state charity law issues. In addition, state receipt of the names of EOs applying for Section 501(c)(3) status would help states monitor startup entities that cease operations before the IRS responds to their Form 1023 applications. State receipt of information about EOs receiving a proposed revocation of exemption would raise immediate questions about whether those organizations' assets are being properly applied to charitable purposes as required by state law.

Because of limitations the PPA placed on how such information is received and used under Section 6103, only three state charity offices currently subscribe to the PPA information sharing regime, despite the information's usefulness to all state charity offices.<sup>25</sup> Most state charities agencies have no system set up to meet the safeguards required by Section 6103 and lack the resources to establish such a system.<sup>26</sup> For information stored on computers, made

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<sup>24</sup> State charity regulators also would welcome receiving information they received from 1976 until the 2006 enactment of the PPA. The PPA actually decreased disclosure of information to the states because only states participating in information sharing now receive the pre-PPA notifications of final denials, revocations, and notices of tax deficiencies.

<sup>25</sup> As discussed earlier, although the PPA placed additional safeguards on shared information, it also expanded the type of information state charity regulators can receive to include sensitive, confidential information such as revenue agents' reports regarding proposed revocations and notices of deficiencies.

<sup>26</sup> Although only three state charity regulators have signed up for information sharing about EOs since the PPA mandated Section 6103 safeguards in 2006, over 250 other state and federal entities (which are subject to Section 6103 safeguards that have been in place since 1976) receive taxpayer information from the IRS, and virtually all use computer systems to process the data.

available on computer networks, or otherwise stored or transmitted electronically, Section 6103 requires an extensive safeguard system to protect IRS information from unauthorized access and disclosure detailed in over 128 pages in IRS Publication No. 1075. Thus, state charity regulators participating in information sharing limit their receipt of information to paper documents to avoid the substantial burdens of maintaining safeguards required for the maintenance of electronic data, which includes a required audit of the statewide data center.<sup>27</sup>

Further, Section 6103(p)(4) requires state regulators to return or destroy IRS documents which they do not use in judicial proceedings. State charity regulators have expressed concerns that these requirements conflict with state statutes requiring the retention and public inspection of public records.<sup>28</sup> The IRS asserts that these state laws are preempted by the Supremacy Clause of the United States Constitution and that Section 6103 effectively will become meaningless if the information is subject to the vagaries of 50 varying state public disclosure statutes.<sup>29</sup>

Although there is no case law squarely on point, there is strong support for the IRS's contention that such state laws are preempted.<sup>30</sup> The Supreme Court has held that state laws are preempted when they pose such substantial obstacles that they prevent the attainment of congressional objectives.<sup>31</sup> Accordingly, state public record laws compelling public disclosure of information shared with state charity regulators pose obstacles which prevent attainment of congressional objectives to safeguard taxpayer information under Section 6103. Reviewing courts likely would find such state laws preempted.

For the first time, the PPA subjected state charity regulators to the same criminal penalty provisions of the Internal Revenue Code that recipients of tax information have been subject to since the enactment of Section 6103 in 1976. Sections 1224(b)(5) and (6) of the PPA amended Section 7213(a)(2), making it a criminal offense for any state official to willfully

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<sup>27</sup> In order to receive such paper documents, state charity regulators are required to maintain them with strict confidentiality. When the IRS makes a disclosure to a state charity office, a regulator must review the data, log the receipt of the information, and place the data in a file secured by at least two physical barriers (e.g. locked doors and cabinets). See the October 28, 2011, letter from the National Association of Attorneys General to the Senate Finance Committee urging that Congress amend the provisions of Sections 6103, 6104 and 7213 to enable state charity regulators to more freely use information shared by the IRS (the NAAG letter). (Appendix A)

<sup>28</sup> See the NAAG letter (Appendix A).

<sup>29</sup> U.S. CONST. art. VI, cl. 2.

<sup>30</sup> Compare *State v. Howard*, 92 Wash. App. 1018 (1998) (after detailed analysis of Supreme Court preemption standards and the legislative history of Section 6103, court held that Section 6103 did not preempt state court authority to order taxpayer to sign a consent form authorizing release of her federal tax returns), with *Yorkshire v. I.R.S.*, 829 F. Supp. 1199, 1202-03 (C.D. Calif. 1993) (requirements under Section 6103(e)(1) that corporate tax returns be made available to 10 percent shareholders preempted any state constitutional right to privacy afforded corporations).

<sup>31</sup> *Arizona v. United States*, 132 S. Ct. 2492, 2507 (2012); *Crosby v. Nat 'l Foreign Trade Council*, 530 U.S. 363, 373 (2000).

disclose information shared by the IRS under Section 6104(c) in a manner unauthorized by the Internal Revenue Code.<sup>32</sup>

Information obtained from the IRS cannot be disclosed except as authorized by the Internal Revenue Code. Section 6104(c)(4) permits disclosure of tax information in the context of a state judicial or administrative proceeding implicating state charity law issues. This allows disclosures to a court, to an administrative body, or to the EO or its counsel as part of the proceeding. Although the term *proceeding* has been broadly construed, certain disclosures are not permitted, including disclosures to the EO prior to a proceeding or to an expert witness to prepare for a proceeding. After the IRS has disclosed information pursuant to Section 6104(c)(5), state charity regulators then must notify the IRS before subsequently disclosing that same information in a state judicial or administrative proceeding so that the IRS can ensure that a state's disclosure will not seriously impair federal tax administration.

State charity regulators have expressed concerns that after the IRS's initial disclosure to a state charity regulator, Section 6104(c)(5) theoretically permits the IRS to apply a stricter standard before permitting state disclosure in a state's judicial or administrative proceeding. In that event, states risk spending time and resources on developing a state law case only to be told by the IRS that they cannot proceed. In conversations with IRS officials, however, they indicated these state concerns are unfounded because the IRS has not been confronted with this issue while implementing Section 6104(c)(5). By applying the "impair federal tax administration" standard prior to initially disclosing information to participating state agencies, they indicated the IRS likely would simply decline to disclose potentially problematic information to the states.

#### **4. IRS efforts to provide disclosure alternatives**

The practical barriers to information sharing posed by the PPA prompted the IRS to help state charity regulators explore ways to obtain the same taxpayer information from EOs and other sources. State use of such independently verified information does not violate PPA safeguard provisions, because information provided directly to state charity regulators by EOs is not considered tax information subject to Sections 6103, 6104, and 7213. Thus, there are no restrictions on use by state charity regulators of information obtained from the EO, including placing it on a state network computer.<sup>33</sup>

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<sup>32</sup> State charity regulators believe that application of such criminal penalties to state charity regulators under the PPA is unnecessary compared to other federal-state information sharing regimes which do not utilize criminal penalties (*e.g.*, Federal Trade Commission/state information sharing under 15 U.S.C. § 464(f), 16 C.F.R. § 4.11(c)). There were no disclosure restrictions in IRS information sharing about final confidential IRS actions affecting EOs under Section 6104(c) from 1976 to 2006. As stated in the NAAG letter: "We see no reason why IRS notices of refusals to grant tax-exempt status, proposed revocations of exempt status, or proposed deficiency taxes for prohibited transactions under chapters 41 or 42, such as intermediate sanctions, taxes on self-dealing transactions and similar matters . . . should be subject to the same criminal penalties . . . applicable to individual and corporate income tax return information." (Appendix A)

<sup>33</sup> Similarly, at the ACT's suggestion, the IRS recently modified its website to encourage private complainants referring

In order to obtain information from a target EO, state charity regulators must rely upon an independent source, such as a telephone directory or advertisement, as the ostensible basis for contacting the EO and requesting any recent communication to or from the IRS. However, state charity regulators have expressed concerns that such an inquiry might pose ethical dilemmas for state charity regulators.<sup>34</sup> When a target EO inevitably asks why state charity regulators are seeking information about the EO's correspondence with the IRS, state regulators will be prohibited by Section 6103 from disclosing that their inquiry was premised on the information received from the IRS, and that prohibition may conflict with state regulators' obligation under state bar codes to disclose that information in order not to mislead.<sup>35</sup>

### **5. IRS sharing of state law violations with state charity regulators under the PPA**

The PPA modified Section 6104(c)(2)(D) and for the first time authorized the IRS on its own initiative (and regardless of whether it initiated an examination) to disclose returns or return information of any Section 501(c)(3) organization to state charity regulators if the IRS determines that its information may be evidence of noncompliance with state laws. However, because of limited staff resources, the IRS currently does not routinely examine its cases for state law violations or regularly communicate with state charity regulators about applicable state law standards.

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cases to the IRS to share information about those complaints with state enforcement authorities, because such information received directly from complainants is not return information subject to Section 6103. *See*, IRS Complaint Process for Tax Exempt Organizations, <http://www.irs.gov/uac/IRS-Complaint-Process-For-Tax-Exempt-Organizations> (last accessed Apr. 14, 2013).

<sup>34</sup> However, state charity regulators can disclose the secondary sources they used to verify the information.

<sup>35</sup> Although courts would likely find that Section 6103 preempts any state ethical obligation to disclose shared information (see discussion at footnote 31, *supra*), state charity regulators have expressed qualms about placing themselves at risk of violating state ethics codes and other state laws until they have the protection of definitive judicial precedent that such state obligations are preempted by Section 6103.

## **IV. Due Diligence**

### **A. EO Reporting Requirements**

The ACT reviewed the current Form 990-EZ, its instructions and predecessor versions of the form. The IRS provided historical information about the form and statistical data regarding the number of Forms 990-EZ filed annually. The IRS also provided a comparison of information reported and schedules to the Form 990 and Form 990-EZ.

The ACT interviewed IRS officials and staff about issues, challenges, and concerns associated with the Form 990-EZ filing. These issues included errors commonly found in the forms and transparency issues concerning the Form 990-EZ.

The ACT obtained information from members of NASCO<sup>36</sup> about general issues concerning the Form 990-EZ, including input on the transparency provided in the Form 990-EZ filing and state filing requirements which cannot be satisfied by the Form 990-EZ.<sup>37</sup>

The ACT interviewed various practitioners with significant experience with the Form 990-EZ and compliance reporting. The practitioners represent a wide variety of large and small charitable organizations. The group included both legal and accounting professionals who answered a series of questions about the current Form 990-EZ and offered input on potential changes to the filing.

### **B. Customer Education and Outreach**

The ACT interviewed representatives from various stakeholder groups to obtain opinions and suggestions pertinent to customer education and outreach.<sup>38</sup> The ACT interviewed members of the IRS leadership and the Customer Education and Outreach staff in the Exempt Organizations Division, as well as several tax professionals and policy analysts who focus on exempt organizations and representatives of small EOs.<sup>39</sup>

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<sup>36</sup> NASCO is made up of state charity regulators, including Attorneys General, Secretaries of State, and Commissioners of Consumer Affairs, whose responsibilities include oversight of tax-exempt entities. That oversight includes administering state registration and reporting requirements, and ensuring that charitable assets are appropriately managed, charitable fiduciaries fulfill their duties of loyalty and care, donor intent is fulfilled, and fraudulent fundraising is remedied.

<sup>37</sup> The ACT gratefully acknowledges state charity regulators from the following state agencies who provided feedback for this project. They included regulators from California Attorney General's Office, Connecticut Attorney General's Office, Hawaii Attorney General's Office, Massachusetts Attorney General's Office, Michigan Attorney General's Office, Nebraska Attorney General's Office, New Hampshire Attorney General's Office, New York Attorney General's Office, North Carolina Secretary of State's Office, Ohio Attorney General's Office, Oregon Attorney General's Office, and Virginia Office of Charitable and Regulatory Programs.

<sup>38</sup> The ACT gratefully acknowledges and thanks the individuals who were interviewed and contributed information to this report.

<sup>39</sup> The questions varied depending on the interviewee but generally covered the following: (1) How do small and mid-sized nonprofits learn about IRS changes affecting them? What and/or who are a nonprofit's primary source(s) of information about IRS issues? (2) What, if any, IRS educational resources do the small and mid-sized nonprofits use? Do nonprofits engage in annual training for staff and board members? (3) In general, how do you find IRS instructions on completing

The ACT reviewed the results of a survey and focus group interviews that the IRS conducted in 2010 and 2011 to obtain information from representatives of small to midsize EOs regarding the resources they use to learn about and comply with IRS requirements for tax exemption. The survey, which was conducted by telephone, entailed a nationally representative sample of approximately 1,200 EOs stratified by type of 990 filer (i.e., 990-N, 990EZ, 990). Ten focus groups were conducted, eight in person and two by telephone, with each group comprising representatives of organizations with less than \$200,000 in gross receipts and less than \$500,000 in assets.

While both the IRS's and ACT's data collection efforts focused on IRS consumer education and support, they are distinguishable in several respects. First, the ACT's interviews targeted a select group of EO stakeholders most of whom were tax professionals and industry experts. By contrast, the survey and focus groups targeted representatives of EOs only. Second, the ACT relied on a convenience sample of interviewees. The IRS survey and focus groups followed standard social science principles for sampling and interviewing. Finally, the ACT conducted its data collection shortly after the IRS unveiled a major revision of its website and sought information about the utility of the website for purposes of consumer education and support. The IRS survey and focus groups were conducted before the IRS website was revised.

The ACT reviewed existing IRS educational materials including the website, web-based educational materials and tools, and videos. In addition, an ACT member consulted with interested participants from NASCO about general issues concerning (1) how state charity regulators attempted to find and communicate, both directly and through representative interest groups, with very small EOs subject to potential revocation under the PPA; and (2) the extent to which state charity regulator websites included links to the IRS website.

### **C. Information sharing with state charity regulators**

The ACT interviewed former and present IRS staff about the history, purpose, and implementation of the PPA's information sharing provisions under Section 6104(c). A member of the ACT surveyed interested NASCO participants about:

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forms accessible? If not, how might the IRS improve its ability to educate a nonprofit on how to complete the necessary forms? (4) What information does your nonprofit want to receive from the IRS? In what format(s) does the nonprofit prefer to receive information from the IRS? (5) What are your nonprofit's barriers to receiving IRS resources and training? (6) What recommendations do you have for the IRS in how best to leverage its resources in reaching out to small and mid-sized nonprofits?

Using a publicly available IRS database, the ACT identified organizations whose tax-exempt status was revoked for failure to file a Form 990 for three consecutive years but subsequently regained their exempt status. From among these organizations, the ACT selected eight as a convenience sample based largely on availability of their contact information. Five organizations responded, but only four agreed to be interviewed.

- issues concerning the nature, effectiveness, and usefulness of information sharing under Section 6104, both prior to the PPA and after the PPA;
- IRS information sharing about noncompliance with state laws;
- factors influencing their decisions to refer cases to the IRS; and
- factors affecting their sharing of information about IRS referrals with other state charity regulators.<sup>40</sup>

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<sup>40</sup> *See supra* note 37.

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## **V. Conclusion**

### **A. EO Reporting Requirements**

The ACT received a wide range of responses to its questions regarding the Form 990-EZ filing threshold. The responses fell into three general categories. Some felt very strongly that the Form 990 is too complex for smaller organizations and the filing threshold should be increased to allow more organizations to file the Form 990-EZ.

Another group felt—equally strongly—that the Form 990-EZ allows smaller organizations to avoid disclosing information relevant to the IRS, state charity regulators, donors, media, and the public. It recommended that the filing threshold be lowered or the Form 990-EZ be eliminated altogether.

The third group felt on balance that the existing filing threshold is appropriate. Some commentators in the third group suggested that additional information could be added to the Form 990-EZ to enhance disclosure without raising the filing threshold.

The arguments supporting each of these positions are described below along with ACT's own view on the subject.

#### **1. Increase the 990-EZ Filing Threshold**

Advocates of increasing the Form 990-EZ filing threshold have a consistent rationale—the Form 990 is too complex and burdensome for smaller organizations to complete without paid professional help which will take away funding otherwise available for mission purposes. These commentators are in general agreement—while it is possible for a smaller organization to file a complete and accurate Form 990-EZ without professional assistance—this is not the case with the Form 990.

Based on their experience, many advocates for increasing the Form 990-EZ filing threshold believe a significant number of Form 990-EZ filers are staffed by volunteers and do not have the type of complex operations warranting Form 990 filing. They believe the Form 990-EZ, if completed accurately, provides an appropriate level of disclosure for smaller EOs. Advocates generally proposed relatively modest increases to the Form 990-EZ filing threshold, noting that even a small increase in the Form 990-EZ filing threshold will be helpful in relieving what they view as an unnecessary burden on smaller EOs. At the high end, some commentators proposed doubling the current filing threshold to allow Forms 990-EZ to be filed by organizations with gross receipts of less than \$400,000 and total assets of less than \$800,000.

Issues relating to the Form 990 were the subject of hearings at the Oversight Subcommittee of the House Ways and Means Committee on July 25, 2012. At that hearing one witness tes-

tified about the Form 990 and Form 990-EZ and suggested increasing the Form 990-EZ filing threshold to less than \$1 million in gross receipts and less than \$3 million in total assets. The witness testified:

The Redesigned 990 overly burdens small charities and small non-501(c)(3) exempt organizations. In my experience, reporting organizations whose budget is on average under \$1,000,000 of revenue per year are not able to self-prepare the Form and are unlikely to have access to paid or volunteer professional preparers who are well-versed in the Form's intricacies. The present threshold at which the Form 990 is required (and the Form 990-EZ may not be used) for most filers: gross receipts for the year less than \$200,000 and gross assets at year end of less than \$500,000 – should be altered. To more closely tailor the reporting burden to the size of these organizations, my recommendation would be to allow exempt organizations with gross receipts for the year less than \$1,000,000 and gross assets at year end of less than \$3,000,000 to file a Form 990-EZ, modified in key ways, in lieu of the 990. Many will argue that this would exclude too many organizations from the full blown reporting of the Form 990, but I believe the response to that would be to utilize the Form 990 Core Form for most of these filers and modify the reach and extent to which the full Form's ancillary Schedules are required. The full blown Form 990 is too comprehensive for most of the sector's small organizations.<sup>41</sup>

## **2. Decrease the Form 990-EZ Filing Threshold**

Advocates of decreasing the Form 990-EZ filing threshold or eliminating the Form 990-EZ altogether generally approach the issue from a consumer protection standpoint. They observe that Form 990 and Form 990-EZ each have a function separate and apart from IRS tax administration, which is to provide meaningful information about EOs to donors, state charity regulators, the media, and the public. One commentator observed a good case could be made that mandatory disclosure is more warranted for smaller EOs than it is for larger ones because smaller ones are less likely to have marketing staffs, brochures, or websites to provide donors and grant-makers with information about the organizations. In this regard, the commentator argued there is no reason why someone who decides to give \$100 to a smaller charity should receive less information than someone who donates \$100 to a large charity. Both donors will make better decisions if they have more rather than less information.

Advocates of decreasing the Form 990-EZ filing threshold were not sympathetic to the argument that this would impose an undue burden on smaller EOs. One commentator noted nobody ever suggests smaller EOs should receive free utilities simply because they are small, and characterized as “nonsense” any suggestion they should be spared accounting and legal

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<sup>41</sup> Testimony of Eve Borenstein Before the Subcommittee on Oversight, House Ways and Means Committee (July 25, 2012), [http://waysandmeans.house.gov/uploadedfiles/borenstein\\_testimony\\_7.25.pdf](http://waysandmeans.house.gov/uploadedfiles/borenstein_testimony_7.25.pdf) (last accessed Mar. 31, 2013).

expenses that simply reflect normal compliance costs. In this regard, the commentator noted “mom-and-pop” restaurants are expected to be in full compliance with the same food-handling laws as large national restaurant chains and expressed the view that filing the required tax disclosure forms is simply a cost of being in the nonprofit business for all EOs, small and large alike.

A final point made by advocates of decreasing the Form 990-EZ filing threshold is there are numerous examples of smaller EOs that are used to hide abuse. The ability of these smaller EOs to complete the Form 990-EZ rather than the more comprehensive Form 990 can help these organizations hide their tracks. State charity regulators and commentators also note that many smaller, all-volunteer organizations lack adequate internal controls and good governance processes and therefore would benefit from the accountability of having to file the more comprehensive Form 990. In this regard, one commentator noted a plausible case can be made that allowing smaller organizations to file the Form 990-EZ increases compliance burdens by providing state charity regulators and the media with less information to use in identifying abuse and wrongdoing by smaller EOs. Advocates of this position believe any increase in the Form 990-EZ filing threshold will only work to the detriment of donors, grant-makers, state charity regulators, the IRS, media, and the public.

State charity regulators who rely on the Form 990 and Form 990-EZ for their own regulatory purposes share this point of view.<sup>42</sup>

### **3. Retain the Existing Form 990-EZ Filing Threshold**

Advocates of retaining the existing Form 990-EZ filing threshold argue that the current approach strikes the right balance in terms of requiring an appropriate amount of information without imposing an undue burden on smaller exempt organizations. They agree there is a legitimate need to avoid burdening smaller organizations and believe that the Form 990-EZ, if properly prepared, provides adequate information to address the needs of the IRS, donors, state charity regulators, media, and the public.

### **4. The ACT’s View**

In many respects the ACT’s discussion of this issue reflected the diverse views of the various commentators. Some ACT members felt the Form 990-EZ should be abolished altogether or the filing threshold reduced in the belief that organizations incapable of filing a complete and

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<sup>42</sup> State charity regulators would also favor lowering the filing threshold for the Form 990-N since that postcard return does not even require basic reporting of gross receipts and total assets. Indeed, many states require all EOs to file Form 990, Form 990-EZ, or state forms requiring at least rudimentary financial information, because they do not consider the Form 990-N to provide an adequate measure of disclosure.

accurate Form 990 should not be in business. There was also recognition that the job of state charity regulators would be easier if all organizations were required to file Form 990.<sup>43</sup>

Other ACT members were sympathetic to the challenges facing smaller and frequently all-volunteer exempt organizations trying to accomplish missions which they deem of critical importance in meeting their community's needs and the significant difficulties in meeting an IRS Form 990 filing requirement. These ACT members argued that the Form 990-EZ provides an appropriate vehicle for smaller organizations to meet their public disclosure requirements. If anything, they felt that the Form 990-EZ filing threshold should be increased, although perhaps not as dramatically as some commentators have advocated.

In considering this issue, the ACT was also mindful that changes to the Form 990-EZ filing threshold or the information required on the Form 990-EZ could impose significant administrative burdens on the IRS. In the ACT's view, these administrative burdens must be weighed as well, particularly at a time when IRS resources are severely constrained.

After a thorough discussion of all aspects of this issue, a majority of the ACT reached a consensus in favor of retaining the existing Form 990-EZ filing threshold.<sup>44</sup> While it is appropriate for the IRS to consider increasing the Form 990-EZ filing threshold from time to time, the ACT sees no compelling reason for increasing it at this point in time, particularly since the threshold was significantly increased just a few years ago.

In reaching its view that the existing Form 990-EZ filing threshold should be retained, the ACT recognized that the Form 990-EZ does not require as much information and therefore does not provide the same degree of transparency as the Form 990. The effect is to limit the information about smaller organizations that is available to the IRS, state charity regulators,

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<sup>43</sup> Some state charity regulators require all EOs to file a Form 990 irrespective of size to comply with state requirements.

<sup>44</sup> Two ACT members disagree with the recommendation in this section. In their opinion the burdens imposed on the IRS by this proposed recommendation, in particular the burdens associated with modifying the Form 990-EZ (*see* fn 64, *infra*) outweigh the benefits to the IRS and the public. In their opinion it is at best an interim recommendation likely yielding only marginal results largely unknown to both the IRS and the ACT as suggested in the recommendation itself.

They agree the burden on current Form 990-EZ filers may be overstated because of the number of eligible 990-EZ filers who nevertheless file a Form 990 whether required by state charity officials or funders or simply because they choose to do so because of their enhanced transparency to the public and its value to the EO. Further, as expressed in the report, there is significant potential for abuse by smaller exempt organizations which file either the 990-N or 990-EZ with the less than full disclosure contained in the Form 990. For hundreds of thousands of exempt organizations this means either limited or no public transparency or scrutiny as a means to leverage external resources which advance the IRS and state regulatory tax administration goals and benefit all involved in the EO sector.

These ACT members believe there is far less burden and far greater benefit to the IRS and others by simply reducing the filing threshold for the Form 990, but differ on the threshold and their rationale. One ACT member favors lowering the filing threshold for the Form 990-EZ to the pre-2008 level, which was gross revenues of less than \$100,000 and total assets of less than \$250,000.

Another ACT member recommends that the IRS use a single standard Form 990 core form for all exempt organizations with accompanying schedules determined by the EO's response to the core form's questions. Standardizing on a single core form alone will yield significant benefit to the IRS, state charity officials, and the EO sector. A standard Form 990 core form should be accompanied by mandatory e-filing phased in over several years to permit the very small organizations to adjust. See Epilogue, *infra*.

donors, media, and the public. For smaller organizations, a majority of the ACT nevertheless believes that the current Form 990-EZ filing threshold strikes an appropriate balance between the IRS's need for sufficient information to carry out its regulatory functions, to provide a meaningful level of transparency and public accountability, and to minimize unnecessary tax administration burdens on smaller organizations.

The ACT determined that some of the concerns expressed by the various stakeholders could be addressed, at least in part, by expanding the information required for Form 990-EZ filers. For this reason the ACT felt it was appropriate for the IRS to consider the possibility of revising the Form 990-EZ accordingly. We understand that making such changes could require significant IRS resources. The information gathered for this project did not allow us to make an informed judgment regarding whether the administrative cost to the IRS of making such changes is outweighed by the greater resulting transparency provided to the various stakeholders, including the IRS, state charity regulators, donors, media, and the public.

The ACT also lacked information to estimate the number of Form 990-EZ filers impacted by some of these changes and was therefore unable to determine the extent to which these changes would increase the burdens on smaller organizations. Both of these factors would be important in applying an appropriate cost-benefit analysis. Accordingly, while the ACT recommends that the IRS consider potential changes to the Form 990-EZ in the areas identified below, we recognize that the ACT currently does not have enough information to make a concrete recommendation for change.

The ACT suggests two types of potential changes to the Form 990-EZ for IRS consideration. The first is for Form 990-EZ filers to provide certain requested information on the applicable Form 990 schedule rather than on Schedule O, which will make this information more readily accessible to Form 990-EZ readers. The ACT concluded there will be greater transparency if applicable Form 990-EZ filers were required to file several additional schedules. These schedules include:

- Schedule F, which provides information on activities outside the United States and would be particularly relevant to U.S. Friends organizations as well as other small exempt organizations formed to raise money for activities conducted outside the United States;
- Schedule I, which provides information on grants for those Form 990-EZ filers that make grants rather than (or in addition to) conducting direct program activities. This information is currently required to be included on the Form 990-EZ Schedule O;
- Schedule J for Form 990-EZ filers with officers, directors and key employees earning \$150,000 or more;

- Schedule L, Parts III and IV, which provides information on grants made to, and business transactions with, interested persons;
- Schedule M, which provides information on noncash donations; and
- Schedule R, which provides information on related organizations.

We recognize that the changes described above might be applicable to a limited group of Form 990-EZ filers which should be taken into account by the IRS in considering these additions to the Form 990-EZ. In the ACT's view, none of these Schedules are likely to be required by most 990-EZ filers, which is probably why the IRS does not currently require them.

However, for those few 990-EZ filers that have activities outside the United States (Schedule F) or pay more than \$150,000 in compensation to officers, directors or key employees (Schedule J), the information on the applicable Schedules would provide an important window into a type of activity that one would not commonly expect of a smaller EO. In this regard, the ACT believes it is possible that making these changes may impose little or no burden on most Form 990-EZ filers, and an appropriate burden for those organizations whose activities are covered by the Schedules. However, we also recognize, as noted, that making these changes may impose a significant burden on the IRS which must be taken into account, particularly during this time of resource constraints.

Finally, the ACT suggests that the IRS consider the possibility of requiring all Form 990-EZ filers to answer certain questions that are currently found on the Form 990 but not on the Form 990-EZ. These include certain questions from the Form 990 that the ACT believes might provide an additional level of transparency that would be particularly relevant to the IRS, state charity regulators, the media, and/or the public. In the ACT's view, questions of particular relevance include:

- whether the organization has and complies with a conflict-of-interest policy (Form 990 Part VI, items 12a-c);
- how many board members are independent (Form 990 Part VI, items 1a and b);
- whether there has been a significant diversion of funds (Form 990 Part VI, item 5); and
- whether the organization follows appropriate practices in setting compensation (Form 990 Part VI, items 15a and b).

In making this suggestion, the ACT is mindful that the IRS is undertaking a governance study of a statistically valid sample of Section 501(c)(3) and Section 501(c)(4) EOs to de-

termine whether governance practices might be useful indicators of tax compliance.<sup>45</sup> The results of this study may help inform an IRS determination of whether it would be appropriate to add some governance questions to the Form 990-EZ and, if so, which questions would be the most appropriate.

## **5. Recommendations**

- The IRS should retain the existing filing threshold for the 990-EZ.<sup>46</sup>
- The IRS should consider the possibility of requiring Form 990-EZ filers to file the following schedules, if applicable: Schedules F (activities outside the United States); I (grants); J (compensation); L, Parts III and IV (transactions with interested persons); M (noncash contributions); and R (related organizations).
- The IRS should consider the possibility of adding governance questions to the Form 990-EZ after it has an opportunity to consider the findings of the governance study which will evaluate whether particular governance practices may be useful indicators of tax compliance.

## **6. Epilogue**

While this report was in the drafting process, there were three noteworthy events relating to the Form 990 which the ACT believes have the potential to help the IRS EO Division further leverage both internal IRS and external resources.

First, the Aspen Institute released a report which makes the case that providing information through *open data* will unleash the collective ability to assist the IRS and state regulators, increase transparency, spur innovation, and help to understand the full potential of the Form 990 data to governments, the public, and the nonprofit sector. This report offered three primary means to accomplish this objective which are not mutually exclusive: (1) legislative mandate, (2) IRS initiative, and (3) third party platform development.<sup>47</sup>

Second, after the Aspen Institute's report and consistent with *open data*, the IRS released Statistics Of Income data in a downloadable space-delimited ASCII file format, which can be downloaded and electronically imported into commonly available software like Microsoft Excel and Access. Currently, the data released provide more information for a limited number of EOs than has been previously available from the IRS, including other SOI data already available on the IRS website. The data is open to the public, though not always in a format

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<sup>45</sup> See, "IRS Exempt Organizations FY 2012 Annual Report and FY 2013 Workplan" at 10, [http://www.irs.gov/pub/irs-tege/FY2012\\_EO\\_AnnualRpt\\_2013\\_Work\\_Plan.pdf](http://www.irs.gov/pub/irs-tege/FY2012_EO_AnnualRpt_2013_Work_Plan.pdf) (last accessed Mar. 31, 2013).

<sup>46</sup> Two ACT members disagree and believe the filing threshold should be reduced. See *supra* note 44.

<sup>47</sup> See generally, "Information for Impact: Liberating Nonprofit Sector Data," Beth Simone Noveck and Daniel L. Goroff (The Aspen Institute, Jan. 2013), [http://www.aspeninstitute.org/sites/default/files/content/docs/events/psi\\_Information-for-Impact.pdf](http://www.aspeninstitute.org/sites/default/files/content/docs/events/psi_Information-for-Impact.pdf) (last accessed Mar. 26, 2013).

which opens up easily for uses with typical consumer software programs. It is available at no cost.<sup>48</sup> The IRS is to be commended for releasing more data in an electronic format which leverages both IRS and external resources.

Finally, the Department of the Treasury released explanations for its recommendations to make Form 990 e-filing mandatory for EOs.<sup>49</sup> Reasons given for these recommendations include:

- improved quality of data used by the IRS for tax administration;
- timeliness of public disclosure for return data;
- more accurate and complete data;
- donors' use in making more informed contribution decisions and by others to understand the exempt sector;
- creating information tools and services useful to the sector;
- usefulness to state and local regulators, charity watchdog groups, charitable beneficiaries and the press; and
- lower processing costs than paper returns.<sup>50</sup>

The Treasury Department's recommendations directly speak to how Form 990 e-filing will leverage IRS, state charity regulators, and external resources, and benefit the public and others in the EO sector when fully deployed.

The ACT applauds these initiatives.

## **B. Customer Education and Outreach**

While the IRS devotes considerable resources to customer education and outreach, reaching small and midsize EOs is an ongoing challenge. The interviews the ACT conducted generat-

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<sup>48</sup> See "SOI Tax Stats – Annual Extract of Tax-Exempt Organizational Data," <http://www.irs.gov/uac/SOI-Tax-Stats-Annual-Extract-of-Tax-Exempt-Organization-Financial-Data> (last accessed Apr.12, 2013). Some of this data is released in a.dat format which is not easily accessible to the occasional user. The IRS is encouraged to release data in multiple formats which result in data which is easily accessible to occasional users and their consumer based software.

<sup>49</sup> This recommendation is consistent with and complements the 2012 ACT recommendation that "[t]he IRS should expedite the internal processes and commit the necessary resources (human, financial, and technological) to transform the Form 1023 into an interactive web-based Form e-1023 that can be filed electronically and stored, transmitted, and disseminated in an electronic database format. This information will serve as the electronic gateway for IRS knowledge about tax-exempt organizations." See "Exempt Organizations: Form 1023 Updating It for the Future," Advisory Committee for Tax Exempt and Government Entities (ACT) "Report of Recommendations" (June 2012, [http://www.irs.gov/pub/irs-tege/tege\\_act\\_rpt11.pdf](http://www.irs.gov/pub/irs-tege/tege_act_rpt11.pdf) (last accessed Apr.12, 2013).

<sup>50</sup> See "General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals" (Department of the Treasury, Apr. 2013), at 174, <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf> (last accessed Apr. 12, 2013).



ed various suggestions for addressing this challenge. The ACT recommends the following to strengthen customer education and outreach.

## **1. IRS Website**

A key finding from the IRS survey and focus groups was that the IRS website is the most important resource for small and midsize EOs for compliance information. Since this research was conducted, the IRS redesigned its website and unveiled it in late 2012.

In general, the individuals we interviewed for this report described the new website as complicated and time-consuming to use. In particular, the redesigned website removed from the IRS's primary landing page ([IRS.gov](http://IRS.gov)) the prominent and direct link to the IRS Exempt Organization's website and information portal for charities and nonprofits.<sup>51</sup> Practitioners found removal of this link to be a significant loss in terms of the accessibility of the EO informational portal. They also commented on the disruption and difficulties in finding information as a result of this redesign.

The consensus among EO representatives was that the new IRS website was not accessible for volunteers and staffs with limited time to devote to tax-related matters. For individuals who go to the website only periodically, one interviewee stated that "they are likely to be frustrated in their efforts to navigate the site and may well decide that they lack the time to find the information that they are seeking." Some commented that the current site seems more oriented to tax professionals. While the current site offers content and tools like easy-to-download checklists and flow charts for tax compliance, they are not easily found or accessed.<sup>52</sup>

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<sup>51</sup> The EO Division does not have direct control over the IRS.gov landing page and, therefore, cannot make changes to this site on its own initiative. The ACT's recommendations for representative changes would apply only to those web resources which the EO Division can modify directly.

<sup>52</sup> For example, see "SOI Tax Stats – Annual Extract of Tax-Exempt Organization Financial Data", <http://www.irs.gov/uac/SOI-Tax-Stats-Annual-Extract-of-Tax-Exempt-Organization-Financial-Data> (last accessed Apr. 17, 2013). In order to obtain calendar year 2012 IRS statistics from the IRS Annual Masterfile Extracts about the numbers of Form 990 filers, Form 990-EZ filers, and Form 990-PF filers (see footnote 2, supra), one must click on the list and description of all available fields to download a Microsoft Excel 97-2003 file which opens easily in a Windows environment. Contained in this downloadable Excel file are the total numbers for 2012, as well as descriptions of other data items found on the various Forms 990. This file download did not contain a comparable listing for the number of 990-N filers. Contained on this page also is a section "Exempt Organization Returns Filed in Calendar Year 2012" with hypertext links to Form 990 Extract 2012, Form 990-EZ Extract 2012, and Form 990-PF Extract 2012, but no comparable Form 990-N Extract 2012 file. These files were not downloadable as an Excel spreadsheet program. Efforts to download and review information from these files were unsuccessful in securing the information in a format which opened up in a Windows or Excel format. The file first was downloaded as a Zip directory containing a file with .dat extension. When opened, Windows first prompted a warning message and then indicated Windows could not open the file. If the user does attempt to open the file, they are directed to find this file format on the web or from a list. Reviewing the IRS SOI Tax Stats – Charities & Other Tax-Exempt Organizations Statistics web page, provides statistical tables for various Form 990 filers, except for Form 990-N. See, <http://www.irs.gov/uac/SOI-Tax-Stats-Charities-and-Other-Tax-Exempt-Organizations-Statistics> (last accessed April 17, 2013). Clicking on the hypertext link titled Snapshot of Charities & Other Tax-Exempt Organizations ' Statistics, the reader is taken to a PDF file which contains information that is current through 2008. See, <http://www.irs.gov/pub/irs-soi/11esgiftsnap.pdf> (last accessed April 17, 2013).

The ACT recommends that the IRS return the link to the Exempt Organization Division's Charities and Nonprofit page on its main web landing page ([IRS.gov](http://www.irs.gov)) and continue its efforts in revising its website to improve its accessibility to individuals engaged in managing small EOs. While EO Division's main landing page contains references and links on the left side of its main page to several topics to include the A-Z Index, Search for Charities, Calendar for Events, Charity and Nonprofit Audits, Free e-Newsletter, Online Training, and Life Cycle, many of its subsidiary pages and other primary categories of organizations do not.<sup>53</sup> For its subsidiary pages, the IRS should create similar links and hypertext which easily lead the reader to these or related sources and available educational materials like Stay-Exempt consistently throughout the website to enable a user to more easily navigate the site from every page. With the exception of a single tab which returns to the main IRS web page, the IRS should consider using the remaining tabs across the top of EO pages as another additional means to index and assist users seeking information about EOs. In some instances, it would be beneficial to add more descriptive information about what is available on the website.<sup>54</sup> This may be especially helpful to the non-professional users. Other primary pages might have direct hypertext links to take a user directly to the resource.<sup>55</sup> The IRS should also consider linking to non-IRS sources like YouTube and providing downloadable PDF files for its web pages and information contained on them.<sup>56</sup> Finally, for the web pages over which EO exercises control, the ACT recommends creating an Internet-based suggestion box link for visitors to EO's web pages to report problems or issues with the website and to offer suggestions on how to improve it.

Common interest networks are an inherently efficient and effective means of transmitting information and are relied upon by EOs for guidance to understand and access IRS resources. The IRS currently reaches smaller EOs by identifying and collaborating with gateway hubs such as state nonprofit associations, funding organizations like foundations, and other EO common interest groups through its Stakeholder Liaison program.<sup>57</sup> As it continues to up-

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The IRS Exempt Organization Division does not own these web pages.

<sup>53</sup> See, Tax Information for Charitable Organizations, <http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations>, last accessed April 17, 2013.

<sup>54</sup> For example, see Statistical information page, <http://www.irs.gov/Charities-&-Non-Profits/Statistical-Information-About-Tax-Exempt-Organizations>, last accessed April 17, 2013.

<sup>55</sup> For example, see Webinars for Exempt Organizations, <http://www.irs.gov/Charities-&-Non-Profits/Webinars-for-Exempt-Organizations>, last accessed April 17, 2013.

<sup>56</sup> For example, see Questions about annual reporting requirements for EO, <http://www.irs.gov/Charities-&-Non-Profits/Questions-about-the-Annual-Reporting-Requirements-for-Exempt-Organizations>, last accessed April 17, 2013. Having PDF files for this information facilitates electronic downloads which can then be transmitted as attached. They can also be printed out and used as training handouts by others.

<sup>57</sup> Over the years, the IRS has sought the assistance of affinity and industry groups to help solve administrative issues that have arisen in the interpretation of the Code or issues in protracted litigation. For example, under the Code, integrated auxiliaries were not required to file Forms 990 because they were principally engaged in religious activities. Former Treas. Reg. § 1.6033-2(g)(5)(ii). The IRS determined that independent social service agencies of a church did not meet the definition of a church, a convention of churches or an integrated auxiliary and were required to file Form 990 information returns. Since a majority of church conferences were supporting and carrying out their religious missions through these enti-

grade its website, the ACT recommends the IRS use this program to systematically map and encourage affiliate organizations (e.g., national and state associations, law firms, accounting firms) to create links to relevant IRS websites and encourage their members to subscribe to EO Update.

## **2. IRS Academic Institutions Initiative**

The IRS Academic Institutions Initiative collaborates with academic institutions nationwide to provide training to small and midsize nonprofits. The host academic institution provides the training site, logistics, and local marketing efforts. The IRS provides the trainers and all participant materials at no cost to these institutions.<sup>58</sup> Since 2010, the EO has held 85 workshops in 28 states and trained approximately 10,000 participants.<sup>59</sup> Interviewees generally referred positively to the activities of universities, colleges, and other types of educational providers to offer such programs to small EOs.<sup>60</sup>

The IRS presenters are the primary reason for the Academic Institutions Initiative's success. Their participation is voluntary and in addition to their regular IRS duties and responsibilities.<sup>61</sup> These day-long sessions are highly interactive. Some interviewees had either attended or served as instructors in these programs. There was a general consensus that these programs were informative, very inexpensive, and well attended. Interviewees also indicated a desire to see greater availability of such programs.

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ties, they sued the IRS to obtain the right not to file the returns. See, e.g., *Lutheran Children & Family Servs.*, 758 F.2d 1228 (8th Cir. 1985); *Tenn. Baptist Children's Homes Inc. v. United States*, 604 F. Supp. 210 (M.D. Tenn. 1984), *aff'd* 790 F.2d 534 (6th Cir. 1986). Because a number of these cases were arising with conflicting results in the various federal circuit courts of appeals, the IRS called together leaders of the major religious denominations to see if a solution could be found under the existing law. Working with these denominations, the IRS developed a definition of an integrated auxiliary that was affiliated with a church or a convention or association of churches and that was internally supported by those denominations rather than the public. The IRS and affinity groups solved the issue without further litigation and costs. This reconsideration and consultation with the religious community resulted in Treas. Reg. § 1.6033-2(h) defining affiliated organizations under the integrated auxiliary rules.

<sup>58</sup> For example, the "Exempt Organizations Participant Text" provides a core curriculum with an easily understandable outline of issues affecting small and medium-sized exempt organizations. The chapters address tax-exempt status; jeopardizing 501(c)(3) status; unrelated business income; gaming activities; employment issues; recordkeeping, Form 990; audit, compliance and complaint processes; and required disclosures. Regrettably, however, this manual could not be located as a downloadable PDF file on the IRS website through a search by its title, catalog number 88908P, or Training 4325-002 (Rev. 10-2008) (last attempted Apr. 12, 2013). All of these designations are on the manual hard copy.

<sup>59</sup> Initially, the IRS self-produced these workshops by working directly with a contractor. In 2010 the IRS began collaborating with academic institutions which hosted the workshop. In 2010 the IRS provided 21 workshops—18 self-produced and 3 in collaboration with academic institutions. In 2011 the IRS held 28 workshops—17 self-produced and 11 with academic institutions. In 2012 all 36 workshops were held in collaboration with academic institutions.

<sup>60</sup> An ACT member participated in the 2009 IRS focus group discussions prior to the launch of this Initiative and then chaired the Initiative's third training session. This multisite, multiday program resulted in the training of more than 600 participants.

<sup>61</sup> To become a member of the EO Presenters Cadre, an IRS employee submits an application in response to an open announcement. IRS employees go through a competitive selection and vetting process in addition to the training they receive. Presenters also are evaluated by the workshop participants.

The ACT recommends the IRS continue these collaborative programs and look to build residual capacity in the collaborating institutions through this initiative. One way for the IRS to build on the successful Academic Institutions Initiative is to create a “train the trainer” program.<sup>62</sup> The IRS could work through these academic institutions, nonprofit associations, and other service providers to train individuals about IRS requirements for EOs. Providing a certification and credentialing program similar to the Enrolled Agents program would provide a level of quality control and an incentive for these institutions to work with EOs in their communities.<sup>63</sup>

There are many associations and organizations with their own ongoing training programs and resources. The IRS should collaborate with these organizations’ training resources and make IRS resources available to them as a component of their annual training. In particular, this could be achieved through collaborations with these organizations by co-creating reusable web-based training available to both the IRS and the training entities.

### **3. Prompts for Educational Opportunities**

Many very small and smaller exempt organizations are overseen by volunteers. Because turnover among board members is high, these organizations often lack board members who are a reliable source of knowledge regarding tax compliance matters. While the IRS provides a wide range of educational materials regarding compliance issues, voluntary board members are not necessarily oriented to seeking and reviewing such materials. Interviewees suggested that the IRS should take advantage of opportunities to reinforce to individuals serving on the boards of the very small and smaller exempt organizations the availability of educational materials from the IRS and the importance of reviewing them. The ACT recommends the IRS take additional steps to encourage and facilitate the use of ongoing educational opportunities as an integral component of good board-governance practices.

The application process of completing the IRS Form 1023 provides an excellent opportunity to provide information about what it means to start and operate an EO. Each applicant could be asked on the current accompanying checklist whether it had reviewed certain IRS materials prior to completing its application (e.g. Stay Exempt or other specific IRS web-based resources and materials).<sup>64</sup> Simply adding a question to this checklist alerts and directs the ap-

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<sup>62</sup> The ACT recognizes that there are many restrictions which prevent the IRS from partnering with for-profit entities, yet public-private collaborations are a means used to leverage public resources in many contexts. The ACT encourages the IRS to explore avenues by which the IRS might leverage its resources through these providers.

<sup>63</sup> While mindful that this may be a resource-intensive suggestion at this time, the ACT believes that the benefits outweigh the burdens. Creating the equivalent of the EO Presenter Cadre in these participating institutions over time will leverage EO’s educational outreach significantly.

<sup>64</sup> Changes to IRS forms (e.g., Forms 1023 and 990) impact both the IRS and the sector. For the IRS this consists at a minimum of implementing, overseeing, and administering the changes in computer systems and programming. Neither Form 1023 nor Form 990 undergoes frequent and significant modifications. If implemented as a stand-alone project, the ACT believes the benefits outweigh these burdens by increasing awareness of and leveraging access to IRS-created educational materials. As the IRS upgrades and moves to implement electronic filing and forms, the ACT believes these changes can

plicant to these specific web-based IRS educational materials, thereby likely increasing their usage.<sup>65</sup> For applicants who choose to review these educational materials, it enhances the Form 1023 application's educational purposes which are already an integral part of the application process.<sup>66</sup> Given high turnover among board members incorporating a similar question on the Form 990 about board governance education and orientation may encourage the use of IRS educational resources. At a minimum the IRS should continue to provide and highlight prominently displayed links and references to specific educational materials in its communications, forms, and instructions with references to IRS materials.

Finally, the IRS performs audits, surveys, compliance checks, and studies as a part of its ongoing regulatory and information gathering needs. The IRS should include questions about current and emerging education practices and opportunities as part of its ongoing regulatory activities. Questions should consider both IRS and non-IRS educational opportunities and materials.

#### **4. Recommendations**

- The IRS should continue to revise its website and improve its accessibility to individuals engaged in managing small exempt organizations. This should include the creation of prominent links beginning with the IRS main web landing page and the addition of links that visitors can use to report problems and that offer visitors guidance for navigating resources available on the site. The IRS should also encourage state charity regulators and affiliate organizations to create links to the IRS website.
- The IRS should continue to support its Academic Institutions Initiative and other collaborative educational programs and look to build residual capacity in the collaborating entities. The adoption of a “train the trainer” model is an important consideration in this regard.

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be integrated easily into the overall design and implementation with minimal burdens. Similarly, we believe the benefits to the sector outweigh any actual or perceived burden. Many very small and smaller EOs do not avail themselves of professional advice often for budgetary reasons. For them, access to a publicly available resource created by the IRS may be the most significant, if not only, access to credible educational materials and information about their legal and tax requirements. Directing an applicant to specific IRS resources at their inception during the one-time Form 1023 application provides an early introduction and awareness to the legal and regulatory tax regime for exempt organizations with lasting benefits to the applicant, the public, and the IRS.

<sup>65</sup> During the drafting of this report, the ACT reviewed an Interactive Form 1023. This form is a web-based, interactive, and downloadable PDF file. As applicants complete each field they are provided with integrated electronic hypertext links to additional IRS reference materials and explanations to assist them in completing this form. The form will permit an applicant to link automatically to and complete any required schedules with links to reference materials. When completed, the applicant will download, print, and mail a completed Form 1023 paper form to the IRS. It is anticipated the Interactive Form 1023 will serve as an interim step toward the full deployment of electronic data base Form e-1023 outlined in the 2012 ACT recommendations. See “Report of Recommendations” at 69-122 (June 6, 2012), [http://www.irs.gov/pub/irs-tege/tege\\_act\\_rpt11.pdf](http://www.irs.gov/pub/irs-tege/tege_act_rpt11.pdf) (last accessed Mar. 26, 2013).

<sup>66</sup> See, the 2012 ACT report, *supra*.

- The IRS should take additional steps to encourage and facilitate the use of ongoing educational opportunities as an integral component of good board-governance practices. These steps should include adding prompts to checklists that direct consumers to available educational resources for good governance.

## **C. Information Sharing with State Charity Regulators**

### **1. State Charity Regulator Participation in IRS Information Sharing Under the PPA**

The IRS has shown remarkable resilience in seeking to educate state charity regulators about information sharing constraints under the PPA in the face of substantial state reticence to deal with previously described PPA burdens. After the passage of the PPA, IRS staff worked with NASCO to provide information concerning the PPA's requirements to NASCO members. IRS staff gave presentations at several NASCO conferences to inform state charity regulators about the procedures for receiving authorized information and the safeguard requirements of Section 6103(p)(4). The IRS's designated EO Federal/State Liaison has worked tirelessly to educate participating state agencies in the mechanics of PPA participation, provide assistance with the safeguard procedure report, and link state officials with appropriate IRS officials conversant in necessary information technology and security issues. The IRS organized an informative teleconference with NASCO members to explain the information-sharing process and standards. Finally, the IRS initiated collaborative discussions with state charity regulators through an ongoing NASCO/IRS working task force to develop a pragmatic approach for taking advantage of what is presently available under the PPA.<sup>67</sup>

The ACT commends the IRS for this approach. Increased state PPA participation in information sharing will enhance IRS/state enforcement coordination while leveraging limited IRS and state resources.<sup>68</sup> The IRS should continue collaborating with state officials to devise solutions to PPA implementation barriers while avoiding unintended consequences such as state law barriers that limit or nullify their effectiveness. Further, the IRS should continue its efforts to communicate clear, straightforward road maps to the states on how best to implement the information sharing process and to overcome the deterrent effect from the PPA's complex, daunting labyrinth of requirements (e.g., sharing standards and processes such as safeguards for maintaining electronic data). IRS communication about workable processes can only encourage participation by nonparticipating states while facilitating more effective, beneficial participation by those states already participating in PPA information sharing.

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<sup>67</sup> The teleconference call and the working task force have also served to educate state charity regulators about inaccuracies in the NAAG letter (Appendix A). *See, e.g., supra* text accompanying notes 29-31.

<sup>68</sup> To the extent that PPA impediments have been overcome, it is in states' best interest to participate in PPA information sharing, even though salutary legislative changes could streamline the PPA to more efficiently meet its goals. *See supra* note 29. It would appear not to be in states' best interests to decline to participate in a workable information sharing scheme while awaiting possible congressional action to improve that scheme, thus allowing perfection to be the enemy of the good.

Information sharing benefits the IRS as well. There are important synergies among the IRS and state charity officials that can only be fully realized through robust information sharing and coordinated enforcement efforts. Information sharing enhances states' ability to exercise their state law responsibilities by working more cooperatively with the IRS to oversee EOs and ensure the proper administration of charitable assets.<sup>69</sup>

The IRS has limited resources to police the sector. In calendar year 2011 the IRS processed 798,903 EO returns. In fiscal year 2012 the IRS audited or examined 10,743 EO and related taxable returns or approximately one percent.<sup>70</sup> Collaboration leads to enhanced and more efficient collective enforcement efforts by the IRS and state charity regulators. Information sharing leverages IRS resources by allowing state charity regulators to pursue cases which the IRS may lack the resources or authority to undertake. This includes the diversion of charitable assets by EOs in their respective jurisdictions where charitable assets are required to be deployed for the benefit of the public.

The IRS is to be lauded for collaborating with NASCO and recently achieving a major breakthrough which will make IRS/state information sharing significantly more workable under the PPA.<sup>71</sup> The IRS has obtained approval to provide letters to participating states authorizing disclosure of information to EOs as a routine, early part of the information sharing process, thus removing states' concerns about not revealing the basis for their inquiries to EOs. The IRS can issue a blanket approval letter under Treas. Reg. 301.6103(p)(2)(B)-1 allowing state disclosure of information to an EO as part of the paper work-around process, thereby facilitating a state's efforts to obtain copies from target EOs of materials the IRS has provided to state charity regulators under Section 6103. This significant development is generating a great deal of interest among state charity regulators who had previously been reticent about participating in information sharing. IRS issuance of such letters to state charity regulators will remove two significant barriers to state participation in information sharing by:

- removing state concerns about seeking information from a target EO without being able to disclose that the inquiry resulted from information received from the IRS; and

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<sup>69</sup> The ACT does not recommend that the IRS expand its information sharing with state charity regulators to include state law violations, as permitted by Section 6104(c)(2)(D). Although referrals of state law violations would assist both the IRS and state charity regulators in prioritizing and leveraging their limited enforcement resources, they would also impose additional burdens on the IRS, which the ACT believes cannot be justified as leveraging already limited IRS resources. The burden would be especially disproportionate in light of the fact that only three states' charity regulators have signed up for information sharing. In order to educate IRS staff about the vagaries of 50 state laws, the benefits of state law referrals would likely be outweighed by the burdens of learning a host of state law issues important to state charity regulators which may have no counterpart in the Internal Revenue Code, such as governance issues, *cy pres* issues triggered by an EO's radical change of charitable purpose, violation of charitable trusts such as restrictions on endowment funds, and deceptive fundraising practices.

<sup>70</sup> See, *IRS Data Book 2012*, at 33. <http://www.irs.gov/pub/irs-soi/12databk.pdf> (last accessed Apr 21, 2013)

<sup>71</sup> IRS staff broke this positive news to the NASCO working group during a teleconference call on April 11, 2013.

- reducing the likelihood that the target EO would respond by misrepresenting that it never provided the relevant information to the IRS.

Another promising avenue of IRS/state collaboration to make IRS/state information sharing more workable under the PPA is the IRS's ongoing review of various states' civil investigation demand (CID) statutes to determine if they constitute administrative proceedings during which state charity regulators can disclose information received from the IRS to a target EO under Section 6104(c)(4).<sup>72</sup> Under Section 6104(c)(4), the IRS must evaluate which state law processes are "similar to . . . tax administration proceedings under Section 6103(h)(4)" which Section 6103(h)(4) further defines as "administrative proceeding[s] pertaining to tax administration." Such administrative proceedings include examinations (or audits) under Section 7602. Examinations can include taxpayer conferences and a formal review of a taxpayer's books and records to determine tax liability. Examinations can also include compelled document production and compelled testimony under oath. State CID statutes are similar to examinations under Section 7602 because they authorize state attorneys general to issue pre-lawsuit subpoenas compelling depositions and document production in order to investigate potential violations of state charity law.<sup>73</sup>

IRS review will determine which state CID statutes provide for administrative proceedings where state charity regulators can disclose information received from the IRS to a target EO under Section 6104(c)(4). An IRS determination that a state's CID proceedings constitute administrative proceedings under Section 6104(c)(4) will remove state concerns about not revealing the basis for state inquiries to target EOs and will compel EO representatives to respond under oath about their communications with the IRS.

## **2. Enforcement Referrals by State Charity Regulators to the IRS**

The IRS has taken an active role in educating state charity regulators about the process for state referrals of complaints to the IRS and the substance of IRS compliance and examination issues. The IRS has also encouraged state charity regulators to make referrals directly to a designated EO Fed/State liaison. State charity regulators are often the eyes and ears of the IRS on the front lines in regulating EOs and they annually refer many significant cases of abusive practices to the Exempt Organizations Division.

Survey responses of state charity regulators varied widely regarding whether, when, and to what extent they make enforcement referrals to the IRS and what criteria they apply in making such referral decisions. However, there are several consistent themes in their responses. They are more likely to make referrals to the IRS when their state agencies lack sufficient resources to conduct an investigation or prosecution or where state remedies are limited by a

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<sup>72</sup> *E.g.*, Mass. Gen. Laws. ch.12, § 8H.

<sup>73</sup> Such CID statutes are essentially a civil equivalent to a pre-indictment criminal grand jury process.



charity's presence in other states. State charity regulators are also more likely to make referrals to the IRS when there are no significant state issues to pursue.

State charity regulators also reported that they are less likely to make referrals if IRS enforcement might interfere with donor intent or where state charity regulators are seeking restitution payable by the EOs' officers to the EO as a remedy for wrongful inurement. Such restitution remedies can be compromised if the IRS is seeking payment of penalties for excess benefit transactions from those same officers, thus offsetting the officers' financial ability to pay restitution to the harmed EO.

There could be improved IRS/state communication and coordination regarding state referrals of potential enforcement matters to the IRS, to help both the IRS and states prioritize their limited resources.<sup>74</sup> State charity regulators report that both the IRS and state charity regulators unwittingly waste resources and duplicate efforts when they are investigating the same EOs. In addition, the IRS prefers receiving state referrals earlier in the evolution of a case.

Further, the state perception is not always justified that the IRS offsets potential state restitution remedies by requiring payments to the IRS for excess benefit transaction penalties. The IRS sometimes obtains remedies requiring officers to pay restitution to EOs which is consistent with state charity regulators' goals.

Thus, the ACT recommends that the IRS expand its education of state charity regulators about IRS compliance and examination functions, with a particular focus on IRS enforcement priorities and the processes and criteria the IRS applies for determining appropriate remedies such as penalties and restitution. Such state education efforts could foster an increase in state referrals to the IRS while helping state charity regulators clarify and integrate the sometimes conflicting enforcement goals of the IRS and the states.

The ACT also recommends that the IRS encourage states to share information about their IRS referrals with other states through the IRS web site and other means. As described above, information provided by complainants directly to state charity regulators is not considered tax information subject to Sections 6103, 6104, and 7213, whereas Section 6103 prohibits the IRS from disclosing complaint information provided by one state charity regulator to other state charity regulators.

### **3. Recommendations**

- The IRS should continue working with state charity regulators to clarify PPA strictures on IRS sharing of confidential information and to assist in overcoming obstacles to state PPA participation in IRS information sharing.

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<sup>74</sup> The need for improved IRS/state coordination is a function of the limitations of the PPA. It is not a reflection of the IRS's excellent efforts to encourage state referrals and to process such referrals rapidly after it receives them.

- The IRS should encourage increased enforcement referrals from state charity regulators by (a) educating them about IRS enforcement priorities and the processes and criteria the IRS applies for determining appropriate remedies and (b) encouraging them to share information about their IRS referrals with other states.

#### **D. Summary of ACT Recommendations**

##### **The IRS should require more information from 990-EZ filers without changing the filing thresholds.**

1. The IRS should retain the existing filing threshold for Form 990-EZ.<sup>75</sup>
2. The IRS should consider the possibility of requiring Form 990-EZ filers to file the following schedules, if applicable:
  - Schedules F (activities outside the United States);
  - I (grants);
  - J (compensation);
  - L, Parts III and IV (transactions with interested persons);
  - M (noncash contributions); and
  - R (related organizations).
3. The IRS should consider the possibility of adding governance questions to the Form 990-EZ after it has an opportunity to consider the findings of the governance study which will evaluate whether particular governance practices may be useful indicators of tax compliance.

##### **The IRS should enhance its Customer Education and Outreach.**

4. The IRS should continue to revise its website and improve its accessibility to individuals engaged in managing small exempt organizations. This should include the creation of prominent links beginning with the IRS main web landing page ([IRS.gov](http://IRS.gov)) and the addition of links that visitors can use to report problems and that offer visitors guidance for navigating resources available on the site. The IRS should also encourage state charity regulators and affiliate organizations to create links to the IRS website.
5. The IRS should continue to support its Academic Institutions Initiative and other collaborative educational programs and look to build residual capacity in the collaborat-

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<sup>75</sup> Two ACT members disagree and believe the filing threshold should be reduced. *See supra* note 44.

- ing entities. The adoption of a “train the trainer” model is an important consideration in this regard.
6. The IRS should take additional steps to encourage and facilitate the use of ongoing educational opportunities as an integral component of good board-governance practices. These steps should include adding prompts to checklists that direct consumers to available educational resources for good governance.

**The IRS should enhance its information sharing with state charity regulators.**

7. The IRS should continue working with state charity regulators to clarify PPA strictures on IRS sharing of confidential information and to assist in overcoming obstacles to state PPA participation in IRS information sharing.
8. The IRS should encourage increased enforcement referrals from state charity regulators by (a) educating them about IRS enforcement priorities and the processes and criteria the IRS applies for determining appropriate remedies and (b) encouraging them to share information about their IRS referrals with other states.

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Although the specific functions of the IRS and state charity officials are distinct, they share a number of important objectives. While the IRS accomplishes its mission through the enforcement of our federal tax laws and state attorneys general apply state trust, nonprofit corporation, consumer protection, and charitable solicitations laws, the goals of these state and federal regulatory schemes often intersect—both state and federal regulators have material concerns about ensuring against excess compensation, private inurement, waste, fraud, conflicts of interest and other abusive practices. Despite these shared interests, however, a variety of constraints discussed more fully below on the IRS's ability to share "tax return information" with state charity officials frustrate the synergies that would otherwise enhance the effectiveness of the limited enforcement resources available at both the state and federal levels.

It is commonly known that the IRS audits or examines less than one-half of one percent of all charitable organizations exempt under section 501(c)(3) of the Internal Revenue Code. It is also widely accepted that the IRS suffers limited resources to police the sector, in which, according to the National Center for Charitable Statistics, there are 1,127,287 tax exempt 501(c)(3) charities and private foundations administering over \$2,495,197,897,281 in charitable assets. Although federal law requires such organizations to make their informational returns (IRS Forms 990,990EZ or 990 PF) available for public inspection and to state charity officials upon request,<sup>2</sup> prior to the Pension Protection Act of 2006, the IRS was precluded from sharing any other tax return information with state charity officials, including any instances in which the IRS may have discovered or received information or complaints concerning violations of state law. Widespread public access to the income, expenses and governance information of the charitable sector already allows the public and state charity officials to be the "eyes and ears" of the IRS by reporting abuses. In truth, the 50 state attorneys general and other state charity officials are on the "front lines" in regulating charities and annually refer many significant cases of abusive practices to the IRS Exempt Organizations Division.

The National Association of State Charity Officials ("NASCO"), which is affiliated with the National Association of Attorneys General ("NAAG"), has long advocated liberalizing the provisions of IRC §§ 6103 and 6104 to allow the IRS to freely share what is considered protected "tax return information" relating to charitable organizations. Such information-sharing would allow state attorneys general and other state charity officials to pursue cases that the IRS may lack the resources or authority to undertake, including the diversion of charitable assets by organizations in their respective jurisdictions where charitable assets are required to be deployed for the benefit of the public-at-large. In June 2004, NASCO testified to this effect before the Senate Finance Committee. See <http://finance.senate.gov/imo/media/doc/062204mptest.pdf>

### III. THE PENSION PROTECTION ACT OF 2006

The Pension Protection Act of 2006 (the "Act")<sup>3</sup> was intended to respond to the circumstances described above and allowed the IRS to unilaterally share tax return information with state charity officials and share other such information upon request. Regrettably, section 1224(b)(5) and (6) amended IRC §7213(a)(2) to make it a criminal offense for any state official to disclose

<sup>2</sup> Federal treasury regulations also require private foundations to provide their IRS Forms 990PF to state attorneys general in their state of domicile or registration.

<sup>3</sup> Public Law No. 109-280 (Aug. 17, 2006).

information shared by the IRS under IRC §6104(c)(2). Despite the good faith efforts of the IRS Exempt Organizations Division to implement these amendments,<sup>4</sup> what was intended to facilitate the rigorous oversight of the charitable sector by state charity officials has failed to achieve its intended purpose.

#### IV. EXPLANATION OF THE PROBLEM

As a result of the Act subjecting information sharing between the IRS and state charity officials to IRC §7213's criminal penalties, the IRS has had to subject state charity officials, including state attorneys general, to the same informational safeguards imposed on the tax and revenue agencies of the 50 states. A copy of the 106-page IRS Publication No. 1075 that describes the multitude of safeguard procedures to which state charity officials must adhere may be found at the following URL: <http://www.irs.gov/pub/irs-pdf/p1075.pdf>.

These procedures not only create the ethical and legal conflicts described below, they are simply unworkable given the limited resources of state charity officials and should not apply to information regarding the revenue, expenses and governance data of charitable organizations already required to publicly report their financial and operational data. The IRS's understandable safeguards for the protection of confidential federal *income tax* information should be inapplicable.<sup>5</sup> These safeguards, for example, do not permit state charity officials to enter any shared data through a word processing program on any networked computer for inclusion in a civil complaint without complying with a myriad of security requirements that state charity officials do not have the resources to implement. Consequently, despite years of diligent efforts by state attorneys general to obtain information from the IRS, only three state Attorney General offices—New York, California and Hawaii—have entered into information-sharing agreements with the IRS since the adoption of the Act nearly five years ago.

Even the three states that have entered into information-sharing agreements have had to construct an uncomfortable "fiction" to use the data:

1. When the IRS makes a disclosure to the state charity office, an official reviews the data, logs the receipt of the information, and must place the data in a file secured by a least two barriers (doors, cabinets, etc).
2. In order to take investigatory or enforcement action, however, the state charity official must then rely upon an independent source, such as a telephone directory or advertisement, as the ostensible basis for contacting the subject charitable organization and requesting any recent communication to or from the IRS. Following this sort of procedure does not violate the safeguard provisions at issue because

<sup>4</sup> State attorneys general acknowledge and commend the IRS's earnest efforts to administer these changes, educate state charity officials about the new requirements and make information sharing a reality. The IRS and state charity officials continue to enjoy an open dialogue about ways to improve charitable oversight. The comments expressed herein are in no way intended to criticize the IRS's implementation of the Act. The failure of this experiment is not the IRS's doing.

<sup>5</sup> Other than on unrelated business income, charities are exempt from income tax under IRC § 501(c)(3).

information provided directly by the charitable organization is not subject to IRC §§ 6103, 6104 and 7213.

3. If asked, a state charity official is prohibited from disclosing that the inquiry was premised on the information received from the IRS and must hope that the organization voluntarily produces all relevant information and, if not, issue a subpoena for the information.

In addition to the above, the rules of discovery are generally very broad and require disclosure of the tax return information in many, if not most, state jurisdictions. Although discovery rules are only applicable whenever civil or criminal proceedings are instituted, the fact that such disclosure may be required warrants careful consideration about the propriety of states withholding section 6104 tax return information and/or the fact of an IRS referral. The requirement that states must withhold disclosure of section 6104 tax return information will be especially sensitive whenever that information has prompted the state's inquiry. Most well-represented defendants demand to know all of the details underlying a state's enforcement action and are quick to exploit any suggestion of selective prosecution or prejudice due to a lack of candor concerning the identity, timing, or source of a complaint or the basis for the commencement of the action. Although state attorneys general are permitted to disclose and utilize section 6104 tax return information in judicial and administrative proceedings, discovery often occurs well in advance of such proceedings and the prejudicial effect of withholding such information from defendants until the time of trial is likely to risk court-imposed sanctions prohibiting the use of the information. From a practical standpoint, the discovery process will also result in the disclosure of information to third parties beyond the state's control (witnesses, court reporters, etc.).

Moreover, the security requirements create problems even when the shared information is not used to pursue an investigation or enforcement action. Some states have record retention laws that govern the return or destruction of state records which are likely to conflict with the provisions of section 6103(p)(4). Many states have their own versions of the federal Freedom of Information Act (FOIA) which may be sufficiently broad in scope to encompass the shared section 6104 return information. To the extent that return information under section 6104 is included within the scope of such statutes, states may be obliged to produce the information when requested.

In light of all of the above, states receiving section 6104 tax return information that cannot be used more straightforwardly are confronted with both ethical and legal dilemmas.

We see no reason why IRC notices of refusals to grant tax-exempt status, proposed revocations of exempt status, or proposed deficiency taxes for prohibited transactions under chapters 41 or 42, such as intermediate sanctions, taxes on self-dealing transactions and similar matters involving public charities and foundations, should be subject to the same criminal penalties and security procedures applicable to individual and corporate income tax return information. This is all extremely valuable and important information that allows state charity officials to fulfill their statutory mandate. The safeguard requirements have proven unsuccessful and unworkable,




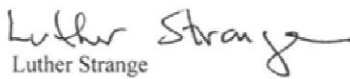
however, and even the three states that have attempted to “play by the rules” feel as if the information obtained directly from the affected charity is akin to fruit of a poison tree.<sup>6</sup>

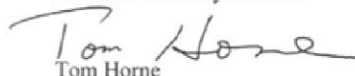
As officials that represent state revenue and taxation agencies, we fully appreciate the fundamental public policy reason for the protection of confidential taxpayer return information—to encourage taxpayers to freely and voluntarily report their income and pay their fair share of taxes. Similar considerations should not apply to organizations that are exempt from income tax, that operate with the public subsidy of tax-exempt status, and who must already publicly report their income, expenses, governance data, disqualified person transactions, excess benefit transactions, changes in exempt purpose and governing documents, embezzlements and losses of funds, etc.—information that is then publicly available online at <http://www2.guidestar.org>.

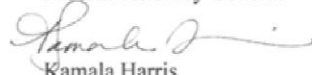
We urge Congress to remedy this situation by amending the federal laws to allow state attorneys general and other state charity officials to more freely obtain and use information possessed by the IRS to protect and promote the public interest we all share – that is, to ensure that charitable assets are lawfully administered at all levels of government.

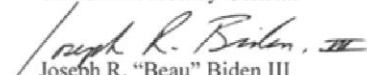
Sincerely,

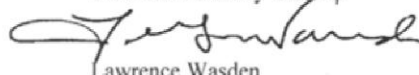
  
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Colorado Attorney General

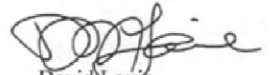
  
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Tom Horne  
Arizona Attorney General

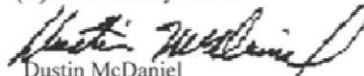
  
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Joseph R. “Beau” Biden III  
Delaware Attorney General

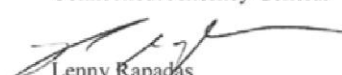
  
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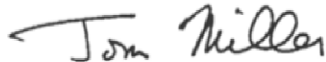
  
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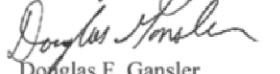
<sup>6</sup> Recently proposed IRS regulations (IRS REG-140108-08) will not address any of the substantive issues presented.

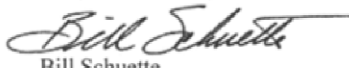
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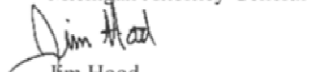
Leveraging Limited IRS Resources in the Tax Administration of Small Tax-Exempt Organizations


  
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Maryland Attorney General

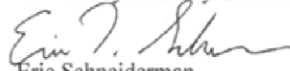
  
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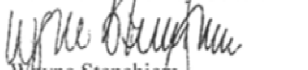
  
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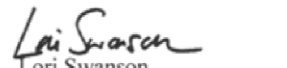
  
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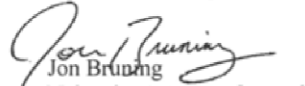
  
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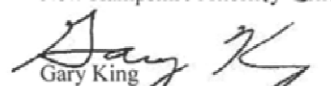
  
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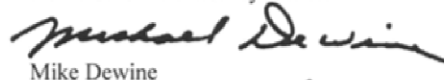
  
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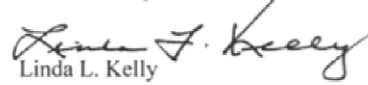
  
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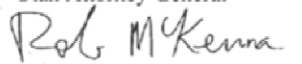
  
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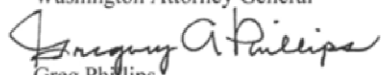
  
Linda L. Kelly  
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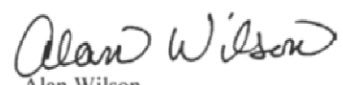
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Guillermo Somoza-Colombani  
Puerto Rico Attorney General

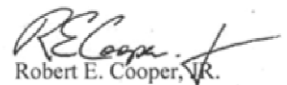
  
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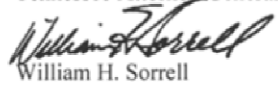
  
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Utah Attorney General

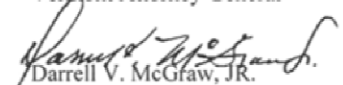
  
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