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September 2019

# TAX-LAW ENFORCEMENT

## IRS Could Better Leverage Existing Data to Identify Abusive Schemes Involving Tax-Exempt Entities

Accessible Version

## Why GAO Did This Study

Abusive tax schemes contribute to the tax gap and threaten the tax system's integrity. When abusive tax schemes involve tax-exempt entities, they also can erode the public's confidence in the charitable sector.

GAO was asked to review what is known about abusive transactions involving tax-exempt entities and how IRS addresses them. This report, among other things, (1) describes ways in which taxpayers have abused an entity's tax-exempt status; (2) examines trends in IRS's compliance efforts; and (3) assesses how IRS identifies emerging abusive tax schemes involving tax-exempt entities.

GAO reviewed research on tax schemes involving tax-exempt entities, and interviewed relevant professionals and researchers about tax schemes involving tax-exempt entities; compiled statistics from IRS audit and disclosure data; and compared documentation and testimony from IRS officials on IRS programs and guidance from its operating divisions with certain internal control and GAO fraud framework criteria.

## What GAO Recommends

GAO is making five recommendations to IRS to strengthen its internal controls, including that it link data across operating divisions, test the ability of a database to facilitate analysis of audit data, and use existing analytic tools to further mine information on tax forms. In commenting on a draft of this report, IRS agreed with all of GAO's recommendations.

## TAX-LAW ENFORCEMENT

### IRS Could Better Leverage Existing Data to Identify Abusive Schemes Involving Tax-Exempt Entities

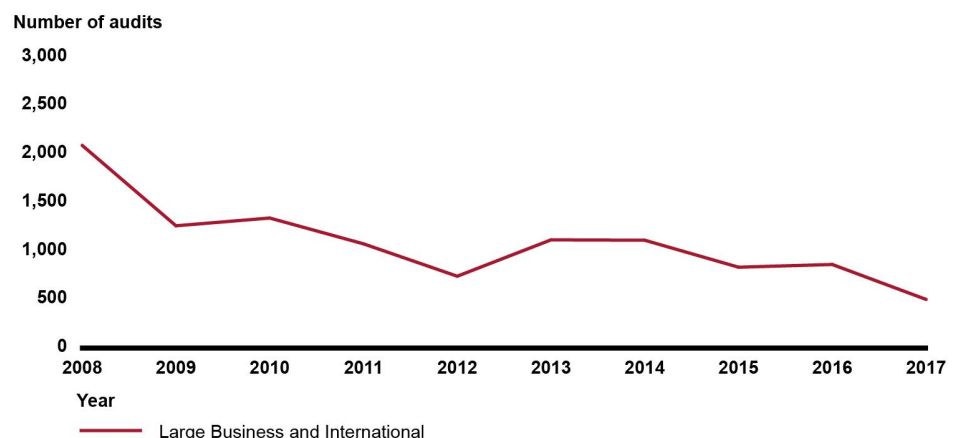
#### What GAO Found

Taxpayers have used a variety of abusive tax schemes involving tax-exempt entities. In some schemes, the tax-exempt entity is complicit in the scheme, while in others it is not. For example, an abusive tax scheme could involve multiple donors grossly overvaluing charitable contributions, where the tax-exempt entity is not part of the scheme. Conversely, some patient assistance programs—which can help patients obtain medical care or medications—have been used by pharmaceutical manufacturers to make charitable donations that can be viewed as furthering private interests.

Internal Revenue Service (IRS) audits of abusive tax schemes are trending downward, as the figure below shows audits by IRS's Large Business and International division. This trend has occurred amid generally declining IRS resources and corresponds with an overall decrease in audit activity by IRS over recent years.

IRS has a variety of programs working collectively to identify abusive tax schemes involving tax-exempt entities, but some internal control weaknesses exist in its approach. For example, GAO found three ways that IRS data or programs were inconsistent with internal control standards for using quality information. First, database project codes used for identifying data on abusive tax schemes are not linked across IRS's audit divisions and do not consistently identify whether a tax-exempt entity was involved. Second, IRS has not leveraged a database with cross-divisional information to facilitate its analysis and monitoring of audit data across divisions. Finally, IRS has not used existing analytic tools to mine the narrative fields of tax forms. Doing so could provide audit leads on abusive schemes involving tax-exempt entities. These deficiencies inhibit IRS's ability to identify abusive tax schemes and develop responses to those schemes.

**Large Business and International Abusive Transaction Audits, Fiscal Years 2008 through 2017**



Source: GAO analysis of Internal Revenue Service data. | GAO-19-491

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# Contents

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Letter	1
Background	4
IRS's Auditing History	6
IRS's Primary Operating Divisions	7
Examples of Abusive Tax Schemes Illustrate Various Ways That Tax-Exempt Status Can Be Exploited by Individuals or Organizations	10
The Number of Audits Involving Tax-Exempt Entities Generally Declined and Few Tax-Exempt Entities Filed Prohibited Transaction Reports	18
IRS Has a Variety of Programs Working Collectively to Identify Abusive Schemes Involving Tax-Exempt Entities, but Some Internal Control Weaknesses Exist in Its Approach	26
IRS Has Not Assessed Risks That Tax-Exempt Entities Do Not Properly File Form 8886-T	29
Conclusions	35
Recommendations for Executive Action	35
Agency Comments	37

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Appendix I: Scope and Methodology	38
Appendix II: Types of Tax-Exempt Organizations Listed in Internal Revenue Code Section 501	43
Appendix III: Tax-Exempt and Government Entities Budget over Time	46
Appendix IV: Financial Transactions the Internal Revenue Service Requires Taxpayers to Report	47
Appendix V: Internal Revenue Service Tax Return and Audit Data	49
Appendix VI: Descriptions of Internal Revenue Service Programs Addressing Abusive Schemes with Tax-Exempt Entities	62
Appendix VII: Comments from the Internal Revenue Service	64
Appendix VIII: GAO Contact and Staff Acknowledgments	69
Appendix IX: Accessible Data	70
Data Tables	70
Agency Comment Letter	72

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Tables

Table 1: How the Internal Revenue Service Performed on GAO's Assessment Criteria	42
Table 2: Number and Percentage of Internal Revenue Service (IRS) Audits of Total Individual Income Tax Returns, Fiscal Years 2006 through 2018	49
Table 3: Number and Percentage of Internal Revenue Service (IRS) Audits of Total Corporate Tax Returns, Fiscal Years 2006 through 2018	50
Table 4: Number and Percentage of Internal Revenue Service (IRS) Audits of Total Tax-Exempt Organizations and Related Returns, as Reported by IRS for Fiscal Years 2006 through 2015	50
Table 5: Number of Abusive Transaction Audits Conducted by the Small Business/Self-Employed (SB/SE) and Large Business and International Divisions (LB&I) for Fiscal Years 2008 through 2017	51

---

Table 6: Number of Abusive Transaction Audits Conducted by the Tax- Exempt/Government Entities Division (TE/GE) for Fiscal Years 2008 through 2017	51
Table 7: Recommended Tax Change Amount from All Abusive Transactions by the Small Business/Self-Employed (SB/SE) and Large Business and International (LB&I) Divisions for Fiscal Years 2008 through 2017	52
Table 8: Hours Spent Auditing All Abusive Transaction Cases Conducted by the Small Business/Self-Employed (SB/SE) and Large Business and International (LB&I) Divisions for Fiscal Years 2008 through 2017	52
Table 9: Hours Spent Auditing All Abusive Transaction Cases Conducted by the Tax- Exempt/Government Entities (TE/GE) Division for Fiscal Years 2008 through 2017	53
Table 10: Number of Abusive Transaction Audits Conducted by the Small Business/Self-Employed (SB/SE) and Large Business and International (LB&I) Divisions Resulting in Tax Changes during Fiscal Years 2008 through 2017	53
Table 11: Number of All Abusive Tax Avoidance Transaction Audits Conducted by the Tax- Exempt/Government Entities (TE/GE) Division Resulting in Tax Changes during Fiscal Years 2008 through 2017	54
Table 12: Total Number of Abusive Transaction Audits Conducted by the Small Business/Self-Employed (SB/SE), Large Business and International (LB&I), and Tax Exempt/Government Entities (TE/GE) by the Type of Return during Fiscal Years 2008 through 2017	54
Table 13: Number and Percent of Abusive Transaction Audits for Project Codes with a Likelihood of Having an Associated Tax-Exempt Entity Conducted by the Small Business/Self-Employed (SB/SE) and Large Business and International (LB&I) Divisions for Fiscal Years 2008 through 2017	55
Table 14: Recommended Tax Change Amounts from Abusive Transaction Audits for Project Codes with a Likelihood of Having an Associated Tax-Exempt Entity Conducted by the Small Business/Self-Employed (SB/SE) and Large Business and International (LB&I) Divisions for Fiscal Years 2008 through 2017	57
Table 15: Hours Spent Auditing Abusive Transactions for Project Codes with a Likelihood of Having an Associated Tax-Exempt Entity by the Small Business/Self-Employed	

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(SB/SE) and Large Business and International (LB&I) Divisions for Fiscal Years 2008 through 2017	57
Table 16: Number of Abusive Transaction Involving a Tax-Exempt Entity Audits Resulting in Tax Changes during Fiscal Years 2008 through 2017	58
Table 17: Number of Abusive Transaction Involving a Tax-Exempt Entity Audits of Individuals by Adjusted Gross Income (AGI) Category during Fiscal Years 2008 through 2017	58
Table 18: Number of Abusive Transaction Involving Tax-Exempt Entity Audits of Businesses by Size of Business Receipts Category during Fiscal Years 2008 through 2017	59
Table 19: Number and Percent of Abusive Transaction Audits for a Taxpayer Who Declared a Tax-Exempt Entity Conducted by the Small Business/Self-Employed (SB/SE) and Large Business and International (LB&I) Divisions for Fiscal Years 2008 through 2017	60
Table 20: Recommended Tax Change Amounts from Abusive Transaction Audits for a Taxpayer Who Declared a Tax-Exempt Entities Conducted by the Small Business/Self-Employed (SB/SE) and Large Business and International (LB&I) Divisions for Fiscal Years 2008 through 2017	61
Table 21: Internal Revenue Service (IRS) Programs that Address Abusive Tax Schemes with Tax-Exempt Entities	62

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## Figures

Figure 1: How Syndicated Conservation Easements Operate and Where Abuse Can Occur	12
Figure 2: How Donor Advised Funds Operate and Where Abuse or Public Policy Concerns Can Emerge	15
Figure 3: How Patient Assistance Programs Operate and Where Abuse Can Occur	17
Figure 4: The Number of Abusive-Transaction Audits Performed by Tax-Exempt/Government Entities Division (TE/TG), Fiscal Years 2008 through 2017	20
Figure 5: Average Recommended Tax Change Amount for Audits Involving Tax-Exempt Entities by Small Business/Self-Employed and Large Business & International Divisions, Fiscal Years 2008 through 2017	21
Figure 6: The Number of Abusive-Transaction Audits Performed by Small Business/Self-Employed and Large Business & International Divisions, Fiscal Years 2008 through 2017	23

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Figure 7: Average Recommended Tax Change Amount for the Total of All Abusive Transaction Audits by Small Business/Self-Employed and Large Business & International Divisions, Fiscal Years 2008 through 2017	24
Figure 8: Simplified Schematic of How the Internal Revenue Service (IRS) Addresses Abusive Tax Schemes across Its Operating Divisions	28
Figure 9: Internal Revenue Service Tax-Exempt and Government Entities Budget, Fiscal Years 2008 through 2018, Adjusted for Inflation	46
Accessible Data for Large Business and International Abusive Transaction Audits, Fiscal Years 2008 through 2017	70
Accessible Data for Figure 4: The Number of Abusive-Transaction Audits Performed by Tax-Exempt/Government Entities Division (TE/TG), Fiscal Years 2008 through 2017	70
Accessible Data for Figure 5: Average Recommended Tax Change Amount for Audits Involving Tax-Exempt Entities by Small Business/Self-Employed and Large Business & International Divisions, Fiscal Years 2008 through 2017	71
Accessible Data for Figure 6: The Number of Abusive-Transaction Audits Performed by Small Business/Self-Employed and Large Business & International Divisions, Fiscal Years 2008 through 2017	71
Accessible Data for Figure 7: Average Recommended Tax Change Amount for the Total of All Abusive Transaction Audits by Small Business/Self-Employed and Large Business & International Divisions, Fiscal Years 2008 through 2017	71
Accessible Data for Figure 9: Internal Revenue Service Tax-Exempt and Government Entities Budget, Fiscal Years 2008 through 2018, Adjusted for Inflation	72

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**Abbreviations**

AGI	Adjusted Gross Income
IRS	Internal Revenue Service

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LB&I	Large Business and International
SB/SE	Small Business/Self-Employed
TE/GE	Tax Exempt and Government Entities





September 5, 2019

The Honorable Charles E. Grassley  
Chairman  
The Honorable Ron Wyden  
Ranking Member  
Committee on Finance  
United States Senate

Abusive tax schemes used as attempts to evade tax liabilities can be highly technical tax shelters engineered and marketed by firms.<sup>1</sup> These schemes threaten our tax system's integrity and fairness when taxpayers believe that individuals and businesses are not paying their fair share of taxes. Abusive tax schemes also contribute to the tax gap, which refers to the difference between the taxes people and businesses owe, and what they annually pay voluntarily and on time in the United States. In 2016, the Internal Revenue Service (IRS) estimated the average annual gross tax gap for tax years 2008 through 2010 to be \$458 billion. After taking into account its enforcement activities and late payments, IRS calculated that the average net tax gap was \$406 billion per year.<sup>2</sup>

When tax-exempt entities such as charities are involved, abusive tax schemes are even more disruptive, as they also erode the public's

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<sup>1</sup>IRS uses the term "abusive tax avoidance transaction" to refer to a specific tax transaction that reduces tax liability by taking a tax position that is not supported by tax law or manipulates the law in a way that is not consistent with the intent of the law (tax evasion). For purposes of this report, we use the term "abusive tax scheme" generally to refer to a subset of abusive tax avoidance transactions in which the transaction or arrangement involves multiple types of entities. An abusive tax scheme involving a tax-exempt entity is an abusive tax avoidance transaction that leverages the tax-exempt status of at least one of the entities of the transaction in a manner that is inconsistent with, or which contradicts, the legal requirements for tax exempt organizations. This includes, but is not limited to, the requirement under the law that no part of the net earnings of such entity inures to the benefit any private shareholder or individual. See e.g., 26 U.S.C. § 501(c)(3).

<sup>2</sup>GAO, *Tax Gap: IRS Needs Specific Goals and Strategies for Improving Compliance*, [GAO-18-39](#) (Washington, D.C.: Oct. 31, 2017).

confidence in the integrity of the charitable sector.<sup>3</sup> This sector included about 1.3 million religious, charitable, and similar organizations operating in the United States during fiscal year 2017. Researchers estimated that giving to charitable organizations totaled \$410 billion in 2017 or about 2 percent of the U.S. gross domestic product.<sup>4</sup> Exempt organizations, including charities, are afforded favorable tax treatment on the premise that they are organized in accordance with their tax-exempt purpose, according to IRS. Because of their exemption from federal income tax and the deductibility of charitable contributions made to them, 501(c)(3) entities are sometimes used as vehicles to conduct inappropriate schemes. Consequently, IRS must work to identify and address new abusive tax schemes involving charities and other types of tax-exempt entities.

You asked us to review what is known about abusive tax schemes involving tax-exempt entities and how IRS addresses these schemes. This report (1) describes ways in which taxpayers have abused an entity's tax exempt status through abusive tax schemes; (2) examines trends in IRS's compliance efforts and characteristics of taxpayers audited for using abusive tax schemes involving tax-exempt entities; and (3) assesses how well IRS identifies emerging abusive tax schemes involving tax-exempt organizations and what improvements it could make, if any, to that process.

To describe ways in which taxpayers have abused the tax status of a tax-exempt entity, we reviewed research on noncompliance involving tax-exempt entities and IRS documentation on abusive tax schemes that could involve tax-exempt entities. We also conducted interviews with knowledgeable tax, accounting and legal professionals; relevant researchers; and former IRS officials about schemes that involve tax-exempt entities. Based on the documentation and interviews, we selected for description in our report three examples of ways tax abusers can exploit an entity's tax-exempt status. We selected the three examples

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<sup>3</sup>Charitable organizations in this report are those organizations which are tax exempt with regard to their charitable activities under 26 U.S.C. § 501(c)(3). Charitable organizations are "corporations, and any community chest, fund, or foundations, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals." 26 U.S.C. § 501(c)(3).

<sup>4</sup>Donation totals were reported by the Giving USA Foundation in June 2018. The gross domestic product was reported by the Bureau of Economic Analysis in October 2018.

because they represented how abusive schemes generally involved tax-exempt entities; there was documentation on the scheme; there was evidence that the scheme had been carried out recently; and that the schemes were shown to have had an effect on taxation.

To examine trends in IRS's compliance efforts and the characteristics of taxpayers audited for abusive tax schemes involving tax-exempt entities, we collected data from the following IRS business operating divisions (operating divisions) that conduct audits on abusive transactions: (1) Tax Exempt and Government Entities (TE/GE), (2) Small Business/Self-Employed (SB/SE), and (3) Large Business and International (LB&I). We received data extracts from the following computer data systems: (1) TE/GE's Returns Inventory and Classification System; (2) the Automated Information Management System—Centralized Information System, utilized by SB/SE and LB&I; and (3) the Compliance Data Warehouse used by SB/SE and LB&I. We reviewed documentation on the data, discussed the data with IRS officials, and conducted electronic reliability testing; for example, we verified the completeness of analysis variables and the date ranges for our analysis. Based on our review, we determined the data were sufficiently reliable for showing trends in IRS's compliance efforts. We identified audits with potential tax exempt entities by selecting audits based on IRS project codes that IRS agreed were relevant. We also matched the SB/SE and LB&I data with IRS's Form 8886 data file that identified tax-exempt entities. We used these data to produce descriptive statistics on audit and taxpayer characteristics, and IRS compliance efforts for 2008 through 2017. Dollar amounts reported have been adjusted for inflation in 2018 dollars. Additionally, we found that IRS had the capability to do Python optical character recognition analysis of the text fields on IRS Form 8886.<sup>5</sup> We requested that IRS conduct and provide the results of an optical character recognition analysis to show how this capability could be used. IRS ran the analysis using keywords associated with 29 different tax exempt organizations that we identified, such as "charity" and "foundation," which are terms found in 26 U.S.C. § 501.

To assess how IRS identifies emerging abusive tax schemes and to identify potential improvements, we first identified relevant IRS programs, procedures and activities through interviews with IRS officials and reviews of documentation, including the Internal Revenue Manual and our

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<sup>5</sup>Python is a computer open source programming language.

previous reports. We selected criteria appropriate for assessing the programs, procedures, and activities and confirmed the appropriateness of these criteria with IRS. These criteria primarily came from *Standards for Internal Control in the Federal Government* and *A Framework for Managing Fraud Risks in Federal Programs*.<sup>6</sup> We then applied these criteria to IRS's programs and enforcement activities that we had identified. More detailed information on our scope and methodology appears in appendix I, including a full list of the selected criteria we used.

We conducted this performance audit from February 2018 to September 2019 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Background

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### Charitable Contributions

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Section 501 of the Internal Revenue Code provides for tax-exempt status of certain corporations, trusts, and other organizations.<sup>7</sup> This status allows qualifying organizations to claim exemption from federal income taxes. Subsection (c) of section 501 recognizes 28 categories of tax-exempt organizations, ranging from cemetery companies to multiemployer pension plan trusts.<sup>8</sup> Section 501(c)(3), the section that recognizes charitable organizations, applied to approximately 1.3 million organizations in fiscal year 2017. These groups represent the largest number of 501(c) organizations.<sup>9</sup>

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<sup>6</sup>GAO, *A Framework for Managing Fraud Risks in Federal Programs*, [GAO-15-593SP](#) (Washington, D.C.: July 2015), and *Standards for Internal Control in the Federal Government*, [GAO-14-704G](#) (Washington, D.C.: September 2014).

<sup>7</sup>26 U.S.C. § 501.

<sup>8</sup>See appendix II for a list of the types of organizations exempt under 26 U.S.C. § 501(c).

<sup>9</sup>For more information on 501(c)(3) charitable organizations, see GAO, *Tax Exempt Organizations: Better Compliance Indicators and Data, and More Collaboration with State Regulators Would Strengthen Oversight of Charitable Organizations*, [GAO-15-164](#) (Washington, D.C.: Dec. 17, 2014).

Federal tax law permits individual taxpayers and organizations to reduce their tax liability by deducting contributions to charitable organizations on their income tax returns. Individual taxpayers may deduct the amount of a contribution to charitable organizations from their gross income if they itemize their deductions. Charitable organizations provide many types of assistance, such as services for the aging or food and shelter for those in need. Taxpayers may support these activities by making contributions in the form of financial donations or in-kind gifts to qualified organizations.

Federal law allows taxpayers to deduct charitable contributions from their adjusted gross income (AGI).<sup>10</sup> This policy has been in place since 1917.<sup>11</sup> An individual taxpayer may deduct up to 60 percent of his or her AGI for cash contributions, with 20 percent to 30 percent limits applying in some cases.<sup>12</sup> A corporation may claim a limited deduction for charitable contributions made in cash or other property up to 10 percent of its taxable income for the year.<sup>13</sup>

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## Charitable Organizations

An entity seeking tax-exempt status under 501(c)(3) from IRS must submit either a completed Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, along with organizing documents, or a completed Form 1023-EZ. Both Form 1023 and Form 1023-EZ require the entity seeking recognition of its tax-exempt status to provide information regarding its charitable purpose, as well as certain financial data.<sup>14</sup> IRS employees then review the forms to determine the entity's eligibility for tax-exemption status.

Most tax-exempt charitable entities are required to file an annual information return from the Form 990 series. Certain small entities with gross receipts that are normally \$50,000 or less may file Form 990-N

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<sup>10</sup>Adjusted gross income refers to gross income minus adjustments to income such as, for individuals, deductions for education expenses, and Individual Retirement Account contributions. 26 U.S.C. § 62.

<sup>11</sup>Pub. L. No. 65-50 § 1201(2), 40 Stat. 300, 330 (Oct. 3, 1917).

<sup>12</sup>26 U.S.C. § 170(b)(1)(A), (B), (D), and (G).

<sup>13</sup>26 U.S.C. § 170(b)(2).

<sup>14</sup>Only charities that meet certain requirements and have gross receipts of \$50,000 or less and assets of \$250,000 or less may submit a Form 1023-EZ.

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Electronic Notice providing abbreviated information. Although the entity is filing its information return as a tax-exempt organization, the entity must pay employment taxes and taxes on unrelated business income, if applicable.<sup>15</sup> IRS provides programs and products to help the entity understand specific issues related to its tax responsibilities.

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## IRS's Auditing History

IRS personnel can audit an organization's or individual's submitted tax returns and financial information to verify that the reported tax is correct.<sup>16</sup> IRS personnel audited 933,785 individual income tax returns in fiscal year 2017, according to IRS data. This was 0.6 percent of individual returns filed in calendar year 2016. From fiscal year 2006 to fiscal year 2017, the largest number of individual returns IRS audited was 1,564,690 in fiscal year 2010.<sup>17</sup> There was a decrease in audits of individual tax returns after fiscal year 2011, which occurred about the same time that IRS's budget declined by about \$2.1 billion (15.7 percent) from fiscal years 2011 through 2018, after adjusting for inflation.<sup>18</sup>

Concurrent with IRS's declining resources were increasing responsibilities, such as implementing aspects of the Foreign Account Tax Compliance Act and the Patient Protection and Affordable Care Act. We reported in 2014 that budget cuts had resulted in a significant staffing decline and uneven performance at IRS.<sup>19</sup> In March 2019, we reported that IRS was in the early stages of defining and addressing its workforce needs, but IRS officials stated that there was room for improvement in

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<sup>15</sup>Generally, unrelated business taxable income is the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less applicable directly connected deductions and taking into account certain modifications. Generally, an unrelated trade or business is one which is not substantially related (aside from the need of such organization for income or funds) to the exercise or performance of its exempt purpose. 26 U.S.C. §§ 511, 512, 513.

<sup>16</sup>We use the term audit, instead of review or examination, for the purposes of this report.

<sup>17</sup>In fiscal year 2017, there were 327,805 of 933,785 returns selected for audit on the basis of an Earned Income Tax Credit claim; in fiscal year 2011, there had been 483,574 of 1,564,690 returns selected.

<sup>18</sup>For more information about TE/GE's budget, see appendix III.

<sup>19</sup>GAO, *Internal Revenue Service: Absorbing Budget Cuts Has Resulted in Significant Staffing Declines and Uneven Performance*, [GAO-14-534R](#) (Washington, D.C.: Apr. 21, 2014).

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implementing its workforce plans, and that it was working on a corrective action plan that would address deficiencies noted in our report.<sup>20</sup>

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## IRS's Primary Operating Divisions

The operating divisions that, along with conducting audits, carry out service and enforcement, and that deal most often with abusive tax schemes or tax-exempt entities are TE/GE, SB/SE, and LB&I.<sup>21</sup> These divisions interact with taxpayers and entities that file tax returns. In particular, each of the three divisions may audit taxpayers or entities to determine whether information filed was reported accurately. IRS has set one of its cross-divisional objectives as identifying “new types of tax transactions or promotions that are either abusive or potentially abusive requiring different levels of coordination and varying strategies.”

Another of TE/GE's audit objectives is to “promote the highest degree of voluntary compliance with the statutes governing qualification of plans and exemption of certain types of organizations from tax and to determine the extent of compliance and the causes of noncompliance with the tax laws by plans and organizations.” TE/GE accomplishes this objective by auditing charitable organizations' compliance with the tax code through its Exempt Organizations unit.<sup>22</sup> In addition to this function, Exempt Organizations also reviews organizations' tax-exempt status applications and makes tax-exempt status determinations.<sup>23</sup> It also coordinates with other state and federal agencies. Additionally, it audits entities to identify and address noncompliance, where it may propose tax assessments or changes to the tax-exempt status of the audited entity.

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<sup>20</sup>GAO, *Internal Revenue Service: Strategic Human Capital Management is Needed to Address Serious Risks to IRS's Mission*, [GAO-19-176](#) (Washington, D.C.: Mar. 26, 2019).

<sup>21</sup>Another division, Wage and Investment, supports IRS's mission by maintaining an enforcement presence and encouraging the correct reporting of income tax to instill public confidence in the tax system. Audit programs in this division cover mainly refundable credits, like the Earned Income Tax Credit, on Form 1040, U.S. Individual Income Tax Return, which are not in the scope of this report.

<sup>22</sup>TE/GE also oversees certain employee plans, such as retirement plans and Individual Retirement Accounts, and government entities customers, such as state and local governments, and Indian tribal governments.

<sup>23</sup>Certain types of exempt organizations are subject to the restriction that no part of their net earnings inures to the benefit of any private shareholder or individual. See, e.g. 26 U.S.C. § 501(c)(3).

TE/GE uses various enforcement processes, such as referrals from the public and other parts of IRS and data-driven approaches, to select tax-exempt organization for possible audits. IRS projects that Exempt Organizations will receive approximately 1.6 million filings from tax-exempt and government entities in fiscal year 2019, primarily Form 990 series information returns.<sup>24</sup>

SB/SE mainly oversees small businesses and self-employed taxpayers and all other businesses with assets of less than \$10 million.<sup>25</sup> Examples of the types of businesses that SB/SE covers include small-business start-ups, small businesses with or without employees, taxpayers with rental properties, taxpayers with farming businesses, and individuals investing in businesses such as partnerships. Overall, IRS projects that SB/SE will receive approximately 59.4 million tax returns in fiscal year 2019.<sup>26</sup> The Lead Development Center, an office within SB/SE, receives referrals from and facilitates communication between SB/SE and TE/GE on the subject of abusive tax schemes.

LB&I oversees tax compliance of large partnerships, S Corporations, and C corporations with assets of \$10 million or more, as well as individuals with high wealth (those with tens of millions of dollars in assets or earnings) or international tax issues.<sup>27</sup> IRS projects that LB&I will receive approximately 400,000 corporate tax-return filings in fiscal year 2019.<sup>28</sup>

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<sup>24</sup>IRS, Research Applied Analytics, and Statistics, Statistics of Income Division, *Publication 6292 (Rev.9-2017): Fiscal Year Return Projections for the United States: 2017-2024*, (Washington, D.C.: Fall 2017).

<sup>25</sup>These individuals file Form 1040 with schedules C, E, or F, Form 2106, *Employee Business Expenses*.

<sup>26</sup>This figure includes individual income tax, corporation income tax, and partnership returns filings from small business and self-employed individuals and entities. See Internal Revenue Service, Statistics of Income Division, *Publication 6292* for more information.

<sup>27</sup>S Corporations are corporations that elect to pass corporate income, losses, deductions, and credits through to their shareholders for federal tax purposes. 26 U.S.C. §§ 1361, 1366. Shareholders of S corporations are to report the flow-through of income and losses on their personal tax returns and are to be assessed tax at their individual income tax rates. 26 U.S.C. § 1366. For federal income tax purposes, a C corporation is recognized as a taxpaying entity. 26 U.S.C. §§ 11, 1361. A partnership is the relationship between two or more persons who join to carry on a trade or business and also are to pass through its taxable transactions to its partners. 26 U.S.C. § 7701. Because they do not pay taxes directly, S Corporations and partnerships are referred to as pass-through entities.

<sup>28</sup>This figure includes corporate income tax and partnership returns from large and mid-sized businesses. See IRS, Statistics of Income Division, *Publication 6292*, for more information.



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LB&I has developed a compliance strategy to identify potential issues that arise during audits of tax returns.

LB&I also oversees the processing of reportable transaction disclosure filings by those involved in reportable transactions. A transaction includes all the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement. It also includes any series of steps carried out as part of a plan. Transactions become “reportable” (meaning a taxpayer must report it to IRS) when they fall under one or more of the following categories: listed transactions, confidential transactions, contractual protection transactions, loss transactions, and transactions of interest.

A listed transaction is any transaction that IRS has identified as an abusive tax avoidance transaction and has identified in published guidance as a listed transaction. Taxpayers that have engaged in transactions that have tax consequences or tax strategies described in published IRS guidance are required by law to disclose the transaction to IRS.<sup>29</sup> The fact that a transaction must be reported does not mean IRS will disallow the tax benefit, but IRS uses the reports to assess compliance. Appendix IV discusses reportable transaction types in greater detail.

Taxpayers are required to disclose all types of reportable transactions on Form 8886, *Reportable Transaction Disclosure Statement*. Similarly, advisers helping taxpayers conduct reportable transactions are required to file Form 8918, *Material Advisor Disclosure Statement*.

Tax-exempt entities are required to file Form 8886-T, *Disclosure by Tax-Exempt Entity Regarding Prohibited Tax Shelter Transaction*, when the entity is a party to a listed, confidential, or contractual protection transaction, and the entity knows the identify of any other party in the transaction.<sup>30</sup> Tax-exempt entities that are party to a listed or confidential

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<sup>29</sup>26 C.F.R. § 1.6011-4(a), (b)(2). Participation in a listed transaction is described in § 1.6011-4(c)(3), and the specific meaning of participation for a listed transaction is in § 1.6011-4(c)(3)(i)(A).

<sup>30</sup>26 C.F.R. § 1.6033-5 (a). A tax-exempt entity is a party to a listed, confidential, or contractual protection transaction only if the entity: (1) facilitates a prohibited tax shelter transaction by reason of its tax shelter transaction by reason of its tax-exempt, tax-indifferent, or tax-favored status; or (2) is identified in published guidance by type, class, or role, as a party to a listed or confidential transaction. 26 C.F.R. § 53.4965-4.

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transaction may be subject to an excise tax of 100 percent of the income from the transaction. Transactions that require the filing of form 8886-T constitute a different, smaller range of activity than transactions requiring the filing of Form 8886.

The Office of Tax Shelter Analysis, a unit within LB&I, supports LB&I's work by coordinating its tax shelter planning and operations. This office also analyzes information collected from disclosure forms. According to IRS policy, if the Office of Tax Shelter Analysis determines a formal investigation is warranted, it presents the information to the LB&I Technical Tax Shelter Promoter Committee, an office within LB&I that has sole authority to approve any proposed investigations.<sup>31</sup>

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## Examples of Abusive Tax Schemes Illustrate Various Ways That Tax-Exempt Status Can Be Exploited by Individuals or Organizations

Taxpayers seeking to reduce their tax liability through charitable donations may participate in legal tax planning strategies that allow them to maximize their deductions while giving to charitable organizations. In contrast to these legal tax planning strategies involving charitable donations, abusive tax schemes occur when taxpayers conduct transactions that are not supported by established law to improperly claim tax benefits, or that have no economic significance or business purpose other than the avoidance of tax, among other factors.

IRS has long recognized that some charitable donors and tax-exempt organizations have engaged in abusive tax schemes. One such scheme can consist of a donor grossly overvaluing a charitable contribution to obtain a larger deduction on his or her filed tax returns. Another abusive tax scheme can entail a tax-exempt organization providing benefits to a private shareholder or individual.<sup>32</sup> As we previously have reported, the

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<sup>31</sup>The LB&I Tax Shelter Promoter Committee is a subcommittee of LB&I's Tax Shelter Steering Committee, a group that makes key decisions in implementing LB&I's tax shelter program.

<sup>32</sup>IRS, "Inurement/Private Benefit – Charitable Organizations," April 2, 2018, accessed November 2, 2018. <https://www.irs.gov/charities-non-profits/charitable-organizations/inurement-private-benefit-charitable-organizations>.

abusive transactions that comprise abusive tax schemes have been a long-standing, ever-changing, and often hidden problem for IRS.<sup>33</sup>

The following three examples illustrate various ways that an entity's tax-exempt status can be used in transactions that are not supported by law or are inconsistent with the law's intent, and how otherwise legitimate tax-exempt activity can be exploited improperly.

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### Syndicated Conservation Easements

A conservation easement is a legal agreement that grants an organization the right to restrict the development and use of property for conservation purposes with the intent of preserving the land or buildings. If statutory requirements are met, taxpayers may donate an easement to a qualified organization and receive a charitable income tax deduction for the appraised value of the easement.<sup>34</sup> A conservation easement becomes "syndicated" if a person or company promoting the easement (a promoter) offers multiple investors in a partnership or pass-through entity the opportunity to claim charitable deductions based on the value of the easement in return for cash. The Brookings Institution estimated that investments in syndicated conservation easements totaled \$623 million in 2016, an increase of 29 percent from \$484 million in 2015.<sup>35</sup> It further estimated that because tax deductions from syndicated conservation easement contributions generate a benefit greater than the value of the investments themselves, the tax deductions resulted in federal tax revenue loss between \$1 billion and \$1.9 billion in 2015 and between \$1.3 billion and \$2.4 billion in 2016.<sup>36</sup>

According to IRS, in a syndicated conservation easement, promoters purchase land and convey ownership to a pass-through entity, such as a

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<sup>33</sup>GAO, *Abusive Tax Avoidance Transactions: IRS Needs Better Data to Inform Decisions about Transactions*, GAO-11-493 (Washington, D.C.: May 12, 2011).

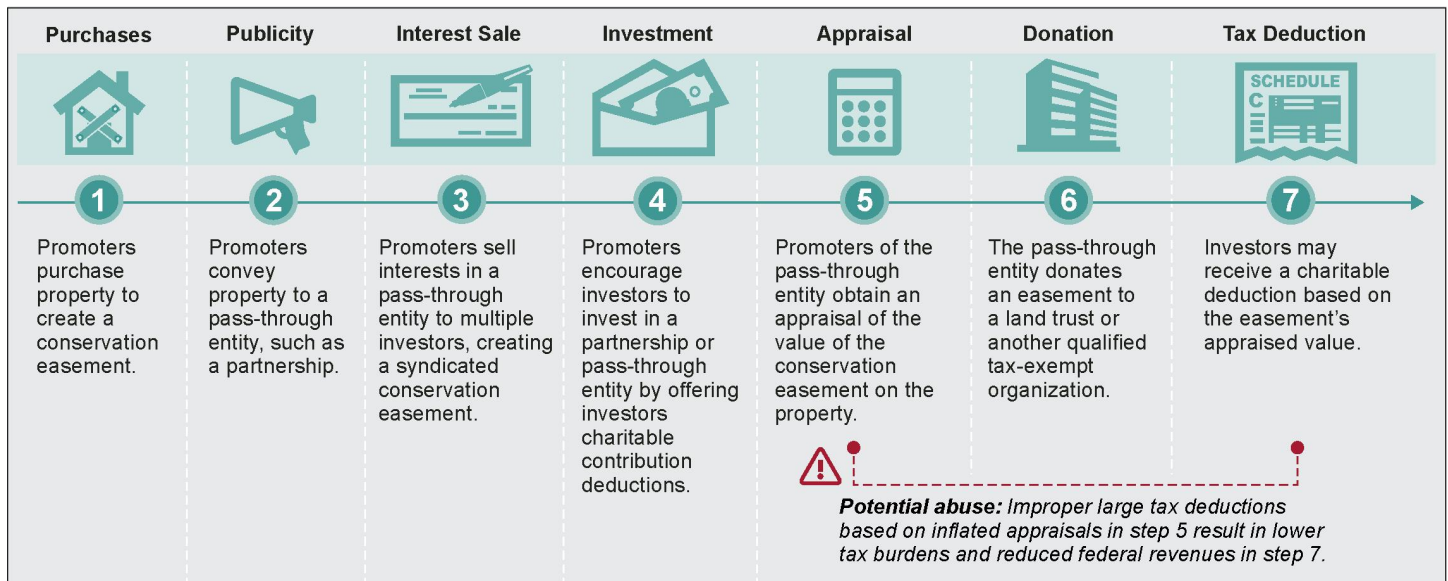
<sup>34</sup>26 U.S.C. § 170(h); 26 C.F.R. § 1.170A-14.

<sup>35</sup>Adam Looney, "Estimating the rising cost of a surprising tax shelter: the syndicated conservation easement," (Washington, D.C.: Brookings Institution, 2017), accessed October 29, 2018, <https://www.brookings.edu/blog/up-front/2017/12/20/estimating-the-rising-cost-of-a-surprising-tax-shelter-the-syndicated-conservation-easement/>.

<sup>36</sup>Looney, Brookings Institution.

partnership.<sup>37</sup> The promoters offer interests in the pass-through entity to prospective investors who are then able to deduct their share of the value of the easement as a charitable contribution. In its guidance, IRS said the conservation easement becomes noncompliant if, for example, the promoters obtain an appraisal that purports to be a qualified appraisal, but that greatly inflates the value of the conservation easement based on unreasonable assumptions about the development potential of the real property.<sup>38</sup> Because the promoters inflate the value of the property, the investors may benefit by claiming a charitable deduction on their tax returns that exceeds their initial investment. Figure 1 shows the steps in the formation of a syndicated conservation easement and the point at which the easement becomes noncompliant when promoters obtain an inflated value for the easement.

**Figure 1: How Syndicated Conservation Easements Operate and Where Abuse Can Occur**



Source: GAO analysis. | GAO-19-491

IRS has indicated its concern about the potential for abuse of conservation easements, whether syndicated or otherwise, when used in ways not supported by the law. In December 2016, the Department of the

<sup>37</sup>A partnership is a relationship existing between two or more persons who join to carry on a trade or business.

<sup>38</sup>A qualified appraisal is defined in 26 U.S.C. § 170(f)(11)(E)(i).

Treasury (Treasury) and IRS issued Notice 2017-10 designating syndicated conservation easements as listed transactions.<sup>39</sup> This notice provides that certain syndicated conservation easements promoted with a return on investment of at least 250 percent will be identified as listed transactions.<sup>40</sup> It also provided details on how Treasury and IRS view these transactions as forms of abuse.<sup>41</sup> Although promoters who abuse syndicated conservation easements exploit tax-exempt entities, the law does not treat the tax-exempt entity as a participant, meaning that even when a promoter is found to use a syndicated easement in a noncompliant manner, the tax-exempt entity associated with the scheme may still be considered compliant.

In addition to the potential for overvaluation of easements, Treasury and IRS considered that syndicated conservation easements may become problematic because of the potential they have to involve transactions that violate the economic substance doctrine.<sup>42</sup> Because of its concerns, IRS has identified taxpayer abuse of conservation easements as a risk area for noncompliance.

Syndicated easements also illustrate how noncompliance can cross the areas of responsibility of IRS's audit divisions. In this case, the beneficiary of the scheme may be a small-business taxpayer (SB/SE's responsibility) or a corporation (LB&I's responsibility), even though the scheme hinges on an inflated appraisal and being able to donate to the tax-exempt recipient (TE/GE's responsibility).

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<sup>39</sup>IRS Notice 2017-10 *Listing Notice-Syndicated Conservation Easement Transactions* (2016).

<sup>40</sup>This rule applies to transactions entered into or after January 1, 2010, effective December 23, 2016. IRS Notice 2017-10 *Listing Notice-Syndicated Conservation Easement Transactions* (2016).

<sup>41</sup>IRS, Notice 2017-10 *Listing Notice-Syndicated Conservation Easement Transactions* (2016).

<sup>42</sup>A transaction has economic substance if: the transaction changes in a meaningful way (apart from federal income tax effects); the taxpayer's economic position; and the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into such transaction. 26 U.S.C. § 7701(o)(1). Any transaction that does not satisfy the doctrine could have its tax consequences disallowed by the IRS. IRS, Notice 2014-58 *Additional Guidance Under the Codified Economic Substance Doctrine and Related Penalties*, accessed November 1, 2018, <https://www.irs.gov/pub/irs-drop/n-14-58.pdf>.

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## Donor-Advised Funds

A donor-advised fund is a fund or account held by a charity that receives contributions from donors who may advise, but not control, how the organization uses the money.<sup>43</sup> The Pension Protection Act of 2006 defined donor-advised funds in the Internal Revenue Code and subjected the funds to new requirements.<sup>44</sup> Because donor-advised fund accounts are operated by charities, contributions to these funds are deductible at a higher percentage of adjusted gross income (generally 50 percent or 60 percent for cash contributions) than donations to private foundations (generally 30 percent).

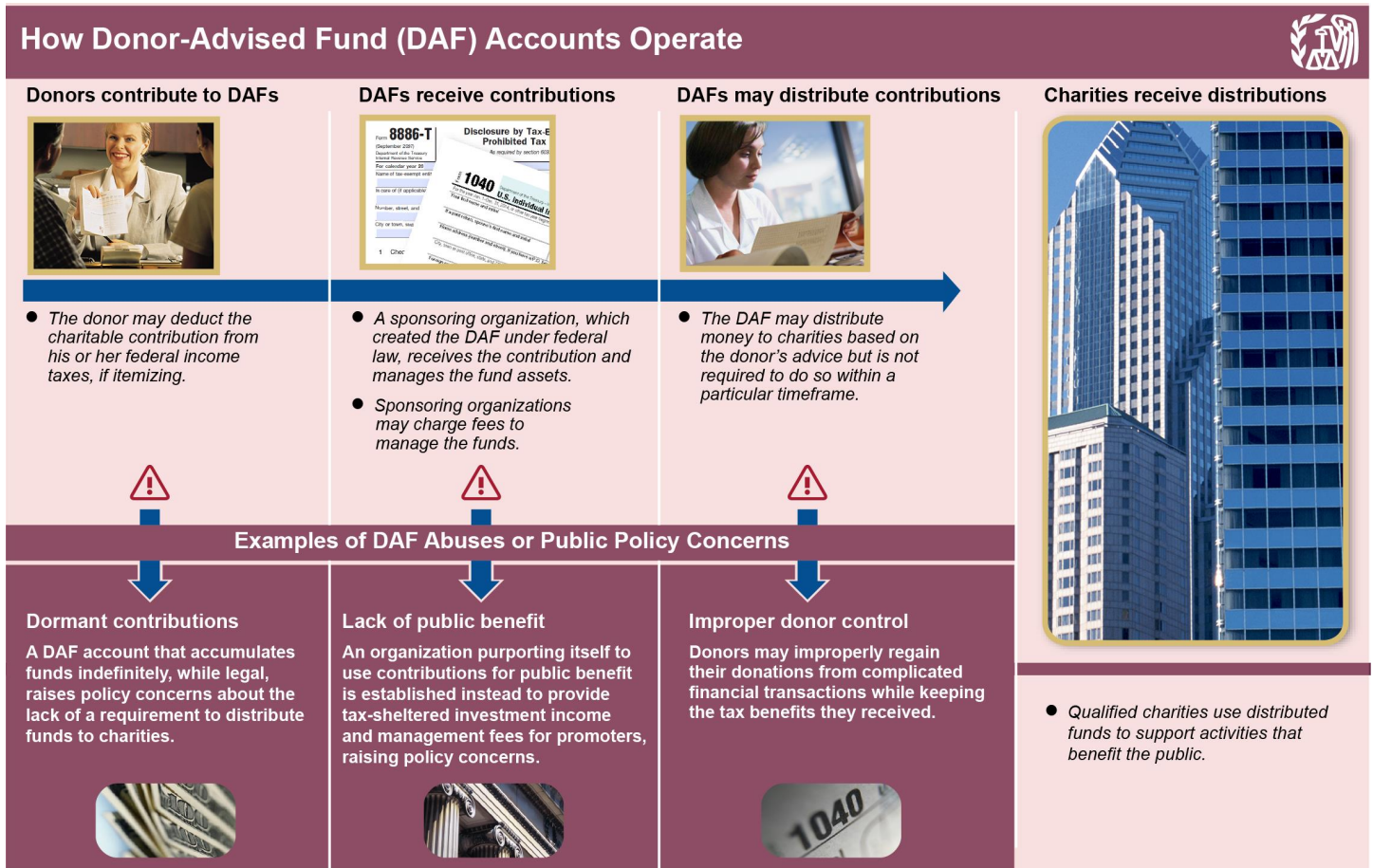
Some donors may use the donor-advised funds in ways that IRS considers improper. For example, prior to tax-law changes in 2006, IRS said that abusive donor-advised funds are those that appear to be established to generate questionable charitable deductions, and provide impermissible economic benefits to donors and their families (including tax-sheltered investment income for the donors). Figure 2 illustrates how donor-advised fund accounts operate and highlights where in the process the parties involved could abuse the funds or raise policy concerns about how donor advised funds have been used.

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<sup>43</sup>More specifically, the donor advised fund or account is separately identified by reference to contributions of a donor or donors; owned and controlled by a sponsoring organization; and in which a donor has advisory privileges with respect to the distribution or investment of money held the fund or account. Once the donor makes a contribution to the organization, the sponsoring organization has legal control over the donation. 26 U.S.C. § 4966(d)(2).

<sup>44</sup>Among the new requirements were excised taxes designed to penalize improper acts of sponsoring organizations of donor-advised funds, their sponsoring organizations, donors, and advisors. Pension Protection Act of 2006, Pub. L. No. 109-208, title XII, subtit. B, pt. 2, §§ 1231-1235, 120 Stat. 780, 1094-1102 (2006), relevant provisions codified at 26 U.S.C. § 4958, 4966, 4967.

Figure 2: How Donor Advised Funds Operate and Where Abuse or Public Policy Concerns Can Emerge



Source: GAO analysis. | GAO-19-491

Donor-advised funds have grown in various measures in recent years, according to data compiled by the National Philanthropic Trust.<sup>45</sup> For example, it reports that from 2013 to 2017, the total grants made by donor-advised funds grew from \$9.83 billion to \$19.08 billion, and contributions grew from \$17.24 billion to \$29.23 billion. Total assets held in donor-advised funds increased from \$57.1 billion to \$110.01 billion as well, according to the organization's study. In 2017, about 463,000 donor-

<sup>45</sup>Examples of donor-advised funds sponsoring organizations are: Fidelity Charitable and Schwab Charitable (financial institution-backed); Silicon Valley Community Foundation and New York Community Trust (community-based), National Christian Foundation, and Jewish Communal Fund of New York (religious-based); and National Philanthropic Trust and American Endowment Foundation (public charity/independent).



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advised funds existed in the United States, with an estimated \$110 billion in assets, according to the National Philanthropic Trust.<sup>46</sup> Some of the largest of these funds in terms of assets are sponsored by financial institutions, religious groups, and community foundations, while others are independent, according to our review of selected donor-advised funds' sponsoring organizations' websites and data from the National Philanthropic Trust.

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## Patient Assistance Programs

Patient assistance programs help patients afflicted with certain medical ailments obtain financial assistance for medical care or free drug products and these programs may qualify for tax-exempt status.<sup>47</sup> Pharmaceutical companies may establish their own patient assistance programs or make monetary donations to independent charities' patient assistance programs. In addition to financial support, pharmaceutical companies may donate medication (through in-kind product donations) to patient assistance programs.<sup>48</sup> Donations such as these allow pharmaceutical companies to claim a limited tax deduction for charitable contributions.<sup>49</sup> If they claim deductions, the deductions may be up to 10 percent of the corporations' taxable income when donating to charities.<sup>50</sup>

The possibility of donors receiving private benefits in excess of the charitable deduction creates potential risks to participating pharmaceutical companies and compliance challenges for IRS, according federal regulators. For example, because independent charity patient

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<sup>46</sup>National Philanthropic Trust, *2018 DAF Report*, (Jenkintown, Pa: 2017), accessed September 11, 2018, <https://www.nptrust.org/reports/daf-report/>.

<sup>47</sup>To qualify for assistance, a patient must meet a number of criteria depending on fund-specific guidelines and the type of medication the patient needs. These criteria may include that they have a total annual household income that falls at or below 300 to 500 percent of the Federal Poverty Level, be a legal resident of the United States or its Territories, and not be covered by any private, public, or Medicare Part D prescription coverage programs, among other criteria. See Medicare's website for more information, <https://www.medicare.gov/pharmaceutical-assistance-program/Index.aspx>.

<sup>48</sup>A qualified contribution is a charitable contribution of certain property by a corporation to a Section 501(c)(3) organization. 26 U.S.C. § 170(e)(3).

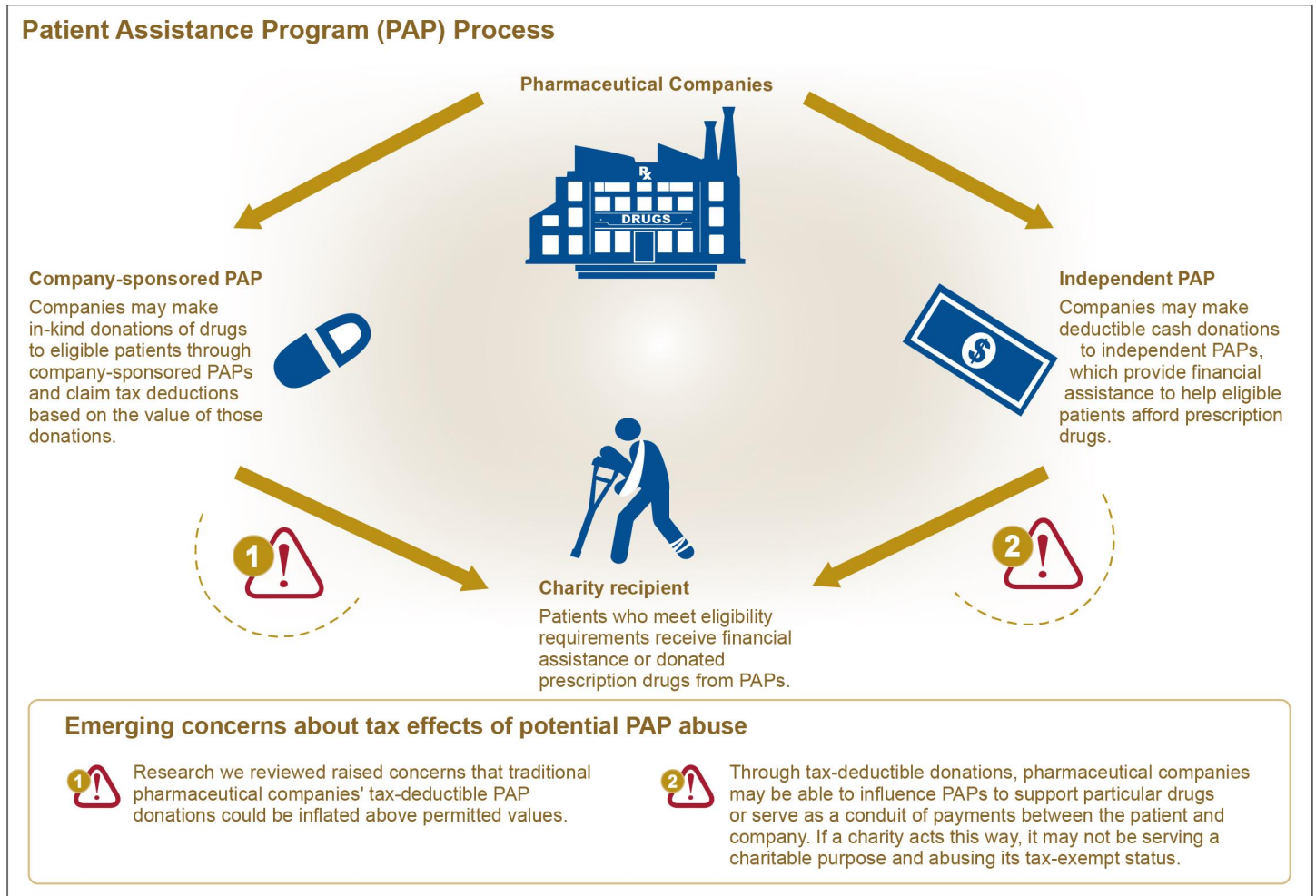
<sup>49</sup>Ten pharmaceutical companies claimed one-sixth of all corporate charity deductions in 2014. Austin Frerick, "The Cloak of Social Responsibility: Pharmaceutical Corporate Charity," in *Tax Notes*, Volume 153, Number 9, (Nov. 28, 2016).

<sup>50</sup>26 U.S.C. § 170(b)(2)(A).



assistance programs may be 501(c)(3) tax-exempt organizations, pharmaceutical manufacturers' profits generated from sales of their products to individuals receiving help from patient assistance programs that they donate to may raise issues of inurement. Figure 3 summarizes how a hypothetical patient assistance program works and highlights points in the process where potential abuse of the program may occur.

**Figure 3: How Patient Assistance Programs Operate and Where Abuse Can Occur**



Source: GAO analysis. | GAO-19-491

The federal government has investigated cases of potential private benefit by pharmaceutical companies and patient assistance programs. For example, IRS filed a court summons in May 2017 in an ongoing investigation of a patient assistance program over concerns that it spent

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the majority of its donations on copayment support that went to patients who were prescribed medication from companies that had donated money to the patient assistance program.<sup>51</sup>

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## The Number of Audits Involving Tax-Exempt Entities Generally Declined and Few Tax-Exempt Entities Filed Prohibited Transaction Reports

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### The Number of Audits Involving Tax-Exempt Entities Generally Declined Across TE/GE, SB/SE and LB&I over a 10-year Period

As shown in the tax scheme examples previously discussed, abusive schemes with tax-exempt entities can involve the tax-exempt entity directly or leverage an entity's tax-exempt status indirectly to reduce taxes. Consequently, the characteristics of audits involving abusive tax schemes, such as which IRS operating division is responsible for the audit, will differ according to the type of scheme. In addition, IRS generally presents information about abusive tax schemes under a category it calls abusive tax avoidance transactions. The abusive tax schemes we have been discussing in this report are a subset of abusive tax avoidance transactions in which the transaction or arrangement involves multiple types of entities. IRS data do not allow us to identify separately the transactions involving multiple entities. The discussion that follows describes trends under the assumption that over time abusive transactions involving multiple entities would closely track total abusive transactions.

TE/GE audited 2,294 tax-exempt entities with what IRS identified as abusive tax avoidance transactions in the 10-year period from fiscal year

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<sup>51</sup>The government has also investigated drug manufacturers' use of foundations to fund patient copayments for the manufacturers' drugs, which may implicate federal health care laws. In particular, under the Anti-Kickback Statute, pharmaceutical companies may not offer, directly or indirectly, any remuneration, including paying patients' copay obligations, to induce Medicare patients to purchase the company's drugs. In May 2018, Pfizer agreed to pay \$23.85 million to resolve claims that it used a foundation as a conduit to pay copayments for Medicare patients taking three Pfizer drugs.

2008 through 2017.<sup>52</sup> As shown in figure 4, the number of abusive-transaction audits fell from a high of 886 in fiscal year 2009 to 10 or less in fiscal year 2017.<sup>53</sup> This decline represented at least a 98.9 percent decrease in audits performed by TE/GE (see appendix V, table 6). The decline in abusive-transaction audits generally corresponds with the overall decrease in audit activity by IRS over recent years (see appendix V, tables 2, 3, and 4). During the same 10-year period, TE/GE assessed a total tax increase of \$107 million based on its audits of tax-exempt entities and the average tax increase per audit was \$46,804.<sup>54</sup> The amount assessed for the tax increase declined from 45.3 million in 2008 to 1.2 million in the merged years of 2016 and 2017.<sup>55</sup>

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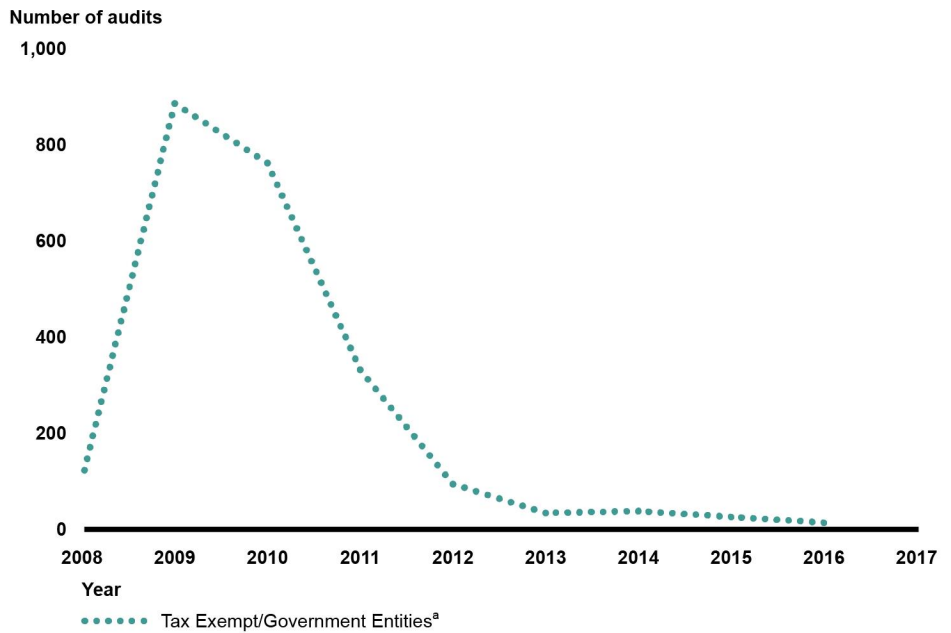
<sup>52</sup>Appendix V includes more information about IRS audits and the results of our data analyses.

<sup>53</sup>To prevent the possible disclosure of taxpayer data we cannot report numbers or amounts for years having 10 or less observations.

<sup>54</sup>All dollar amounts reported in regard to trend data have been adjusted for inflation in 2018 dollars.

<sup>55</sup>We merged the years 2016 and 2017 because the number of audits in 2017 is 10 or less.

**Figure 4: The Number of Abusive-Transaction Audits Performed by Tax-Exempt/Government Entities Division (TE/TG), Fiscal Years 2008 through 2017**



Source: GAO analysis of Internal Revenue Service data. | GAO-19-491

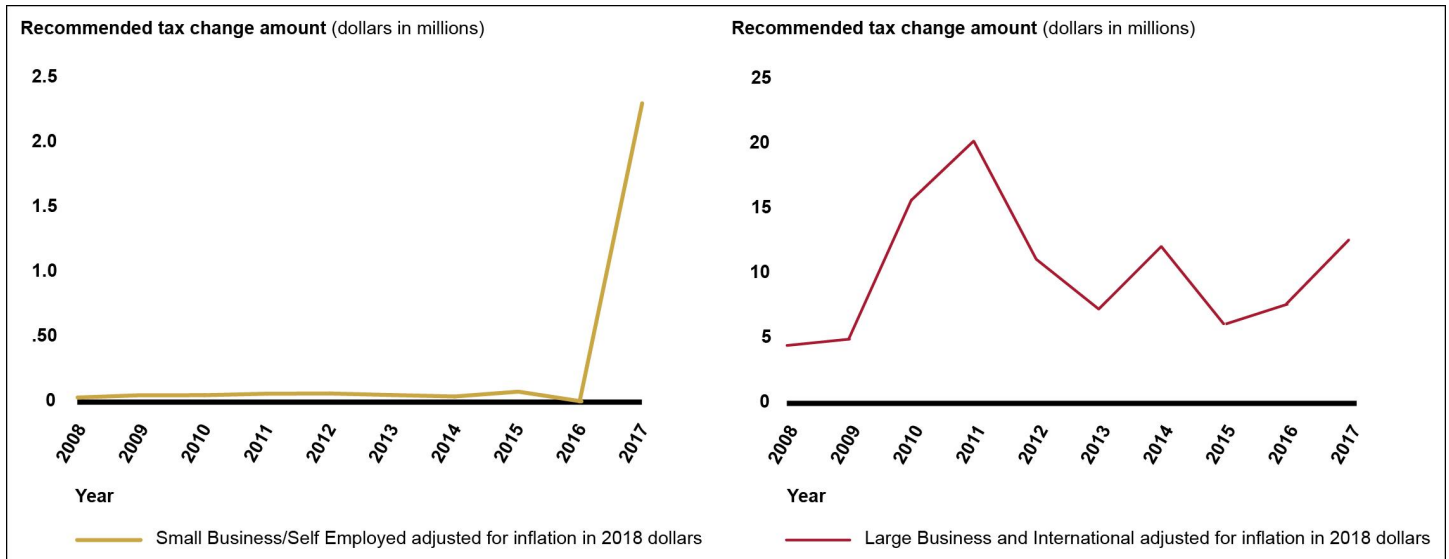
<sup>a</sup> The number of audits in fiscal year 2017 was 10 or less.

The effectiveness and efficiency of the audit process may be reflected in the no-change rate and staff days associated with the audits. The no-change rate—the percentage of audits that results in no tax change—was 13.9-percent (see appendix V, table 11). IRS uses this ratio as an indicator of how effectively IRS identifies noncompliant taxpayers (a lower no-change rate on its audits is consistent with more effective audit selection methods). The lower rate may also reflect higher economic efficiency because less IRS and taxpayer time and other resources are used for auditing compliant returns. On average, TE/GE spent 70 hours per audit of tax-exempt entities from fiscal year 2008 through 2017 (see appendix V, table 9).

Audits involving abusive schemes where taxpayers leverage an entity’s tax exempt status—but the tax-exempt entities are not the subject of the audit—are the responsibility of SB/SE and LB&I. To determine the minimum number of audits these divisions conducted on abusive schemes involving tax-exempt entities, we used IRS project codes that

IRS agreed were relevant.<sup>56</sup> For these project codes, SB/SE and LB&I conducted 4,207 audits over the 10-year period. The numbers of audits generally decreased over the period except for increases in 2012, 2015, and 2017 for LB&I audits and increases in fiscal year 2015 and 2017 for SB/SE audits. Combined SB/SE and LB&I audits fell from 1,176 in fiscal year 2008 to 99 in fiscal year 2017, a 91.6 percent decrease (see appendix V, table 13). SB/SE and LB&I recommended about \$8.3 billion in tax changes over the 10-year period. As shown in figure 5, the average recommended amount was larger for LB&I, but tended to fluctuate more than the SB/SE amounts. The average tax change amount per audit over the 10-year period recommended by SB/SE was \$89,399. The average amount recommended by LB&I was \$8.6 million.

**Figure 5: Average Recommended Tax Change Amount for Audits Involving Tax-Exempt Entities by Small Business/Self-Employed and Large Business & International Divisions, Fiscal Years 2008 through 2017**



Source: GAO analysis of Internal Revenue Service data. | GAO-19-491

<sup>56</sup>Project codes are assigned to examinations in IRS databases. IRS officials stated that once assigned to an examination a project code cannot be changed. They also stated that often, when an examination is first opened, and the project code is assigned, no indication of an abusive tax avoidance transaction exists. IRS does not use project codes specific to certain abusive transactions and does not provide the information needed to identify when a tax-exempt entity was involved with a particular scheme. IRS has a project code for “Conservation and Façade Easements” that we included in our select population. However, no project codes for Donor Advised Funds or Patient Assistance Programs exist. Furthermore, IRS told us there was no record on how often listed transactions arise during examinations. For more details on our methodology, see appendix. I.

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Figure 5 also shows how both divisions had a surge in recommended tax amount changes for 2017 compared to prior years. SB/SE's recommended changes increased from \$270,131 in fiscal year 2016 to \$127 million in fiscal year 2017. LB&I recommended changes increased from \$299 million in 2016 to \$555 million in 2017. IRS officials could not provide an explanation for the surge in 2017 (see appendix V, table 14).<sup>57</sup>

Again, the divisions' resource use may be reflected in staff days and the no-change rate. SB/SE and LB&I combined spent 218 hours, on average, per audit for the audits involving tax-exempt entities identified by project codes (see appendix V, table 15). The no-change rate for SB/SE audits we examined involving tax-exempt entities identified by project code was 10.9 percent. LB&I audits involving tax-exempt entities had a no-change rate of 15.5 percent (see appendix V, table 16).

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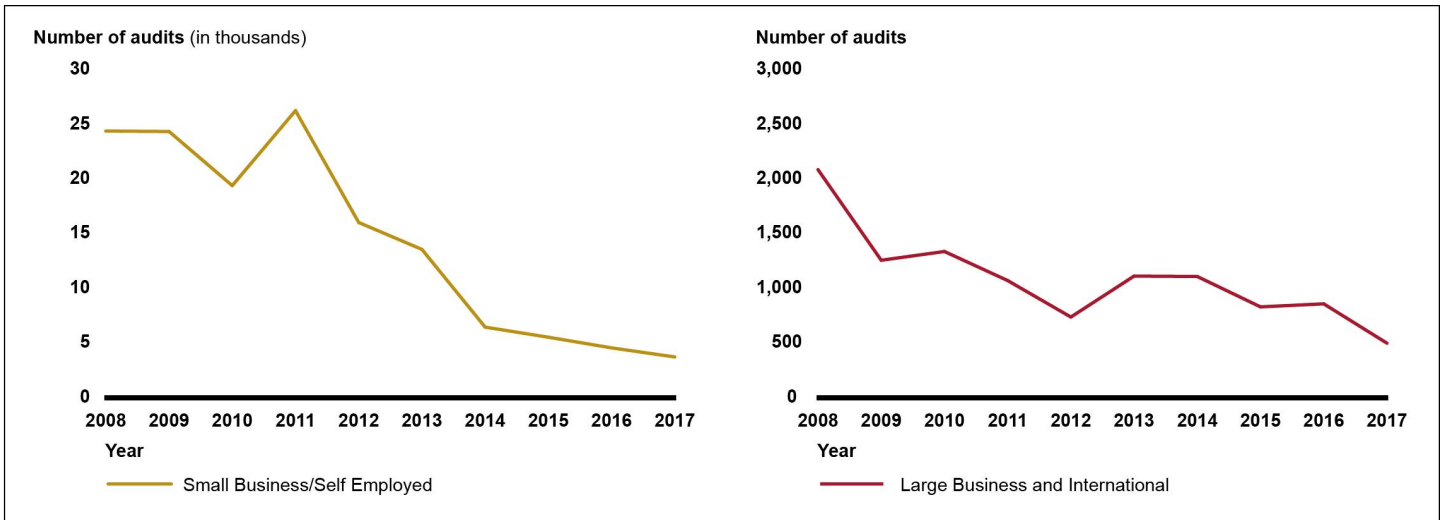
### Audits Involving Tax-Exempt Entities Had Larger Recommended Tax Changes and Used More Staff Hours on Average than the Total of All Abusive Transaction Audits

Numbers of audits of all types of abusive transactions showed a pattern of decline similar to audits involving tax exempt entities. SB/SE and LB&I conducted a total of 155,467 audits involving all types of abusive transactions from fiscal year 2008 to fiscal year 2017. As shown in figure 6, the total number of these audits conducted by each of the operating divisions fell in most years. Abusive transaction audits conducted by SB/SE and LB&I fell from 26,519 in fiscal year 2008 to a low of 4,248 in fiscal year 2017, an 84 percent decrease in audits closed during this period (see appendix V, table 5).

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<sup>57</sup>The increases were associated with work performed under the project code titled, "Reportable Transaction Disclosure Statement." In 2017, this project code represented 97.1 percent of the recommended tax amount change for SB/SE and 99.8 percent for LB&I for the audits we selected on the basis of project codes. Over the 10-year period, this project code accounted for 42.7 percent for SB/SE and 99.8 percent for LB&I.

**Figure 6: The Number of Abusive-Transaction Audits Performed by Small Business/Self-Employed and Large Business & International Divisions, Fiscal Years 2008 through 2017**

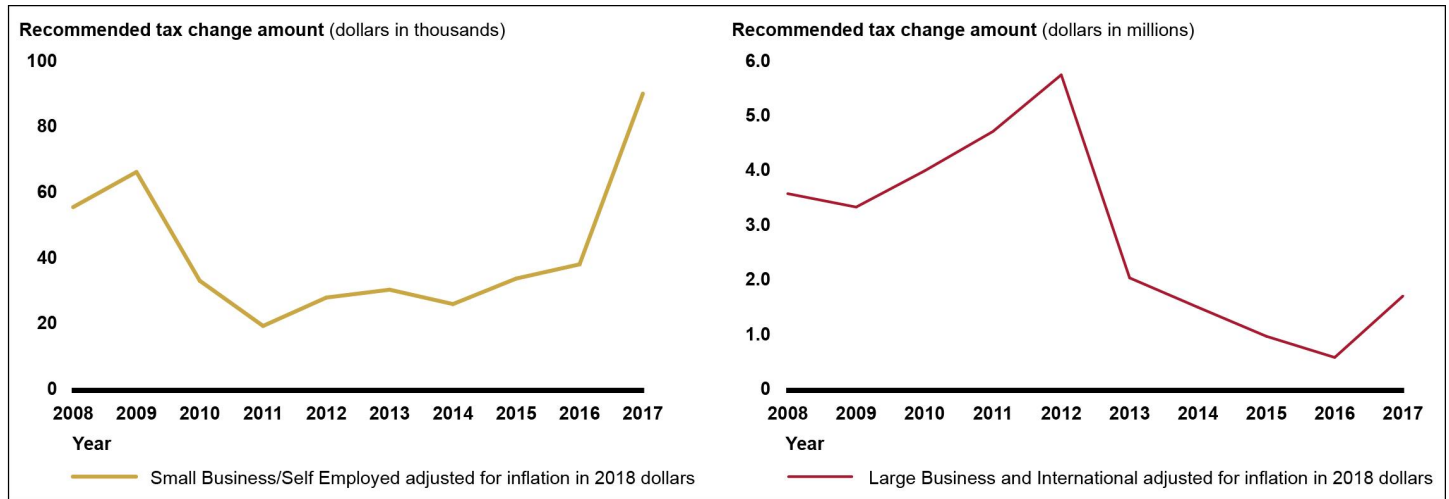


Source: GAO analysis of Internal Revenue Service data. | GAO-19-491

Audits involving tax-exempt entities resulted in higher average tax changes than audits for the total of all abusive transactions. Combined, SB/SE and LB&I recommended a total of \$39 billion in tax changes for the total of all for abusive-transaction audits. As shown in figure 7, SB/SE recommended tax amount changes that averaged \$40,834 per audit and LB&I recommended tax amount changes that averaged \$3 million per audit. The recommended tax change per abusive-transaction audit was larger for audits involving tax-exempt entities than for the total of all abusive-transaction audits in both operating divisions which were (as described above) \$89,399 for SB/SE and \$8.6 million for LB&I.

The total recommended tax amount change for SB/SE decreased from \$1.4 billion to \$339 million, a 75 percent decrease over the period. For LB&I, the recommended tax amount change decreased from \$7.5 billion to \$866 million, an 89 percent decrease (see appendix V, table 7). We estimated audits involving tax-exempt entities identified on the basis of project codes led to SB/SE and LB&I recommending about \$8.3 billion in tax changes over the 10-year period.

**Figure 7: Average Recommended Tax Change Amount for the Total of All Abusive Transaction Audits by Small Business/Self-Employed and Large Business & International Divisions, Fiscal Years 2008 through 2017**



Source: GAO analysis of Internal Revenue Service data. | GAO-19-491

The no-change rate for all SB/SE abusive transaction audits over the period was 8.8 percent. The no-change rate for all LB&I abusive-transaction audits was 14 percent (see appendix V, table 10). Combined, SB/SE and LB&I spent a total of 6.6 million staff hours for the total of all abusive transaction audits from fiscal year 2008 to 2017, spending, on average, 42 hours per audit for all abusive-transaction audits (see appendix V, table 8). As described above, SB/SE and LB&I spent more in resources, 218 hours, on average, per audit of tax-exempt schemes, than the average for the total of all abusive-transaction audits.

### Taxpayers with Audits Involving Tax-Exempt Entities Differed by Income

The majority (88 percent) of taxpayer audits involving tax-exempt entities identified on the basis of project codes for both SB/SE and LB&I had an Adjusted Gross Income (AGI) of more than \$50,000, with about 40 percent of the audits involving the taxpayers with AGI falling between \$100,000 and \$500,000. The SB/SE audits had an average AGI of \$1.2 million and median AGI value between \$200,000 and \$500,000. LB&I audits had an average AGI of \$6.2 million and a median AGI value between \$1.0 million and \$1.5 million. The majority of business taxpayers with abusive-transaction audits involving tax-exempts (about 70 percent) reported zero gross receipts (see appendix V, tables 17 and 18).



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## Taxpayers Reported Tax-Exempt Entities on Thousands of Reportable Transaction Disclosures, While Few Tax-Exempt Entities Filed Prohibited Transaction Reports

While the audit data examined above show the noncompliance IRS has found regarding abusive schemes with tax-exempt entities, information about the taxpayers involved in the transactions can also be derived from the IRS disclosure forms. Most of the taxpayers identified partnerships as the entities involved in the listed transactions that they reported. Of the taxpayer disclosures identifying a tax-exempt entity on Form 8886, 97.8 percent identified the type of reportable transaction as a listed transaction and 95.5 percent listed a partnership for type of entity involved in the transaction.<sup>58</sup> Further, 98.1 percent of taxpayers claimed a deduction from their AGI as the benefit generated by the transaction and 5 percent claimed an ordinary loss as the tax benefit.<sup>59</sup>

The different disclosure reports that IRS receives from tax-exempt entities, taxpayers, and tax advisors contain data that identify the potential involvement of tax-exempt entities with reportable transactions. However, there are differences in the legal filing requirements, the types of information supplied, and the number of disclosure forms filed.

Few tax-exempt entities directly disclose their involvement in prohibited transactions to IRS. Regulations require that certain tax-exempt entities disclose information on a prohibited tax shelter transaction to which the entity is a party.<sup>60</sup> For calendar years 2004 through 2016, IRS received 71 Form 8886-T disclosures from tax-exempt entities that were a party to a prohibited transaction. Moreover, the actual number of filers making disclosures was smaller, only 33, because some submitted multiple forms during the period.

Many more tax-exempt entities were identified by taxpayers filing the Form 8886, which requires a different, broader range of transactions to be

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<sup>58</sup>Type of entity check boxes on the Form 8886 include: Partnership, Trust, S corporation and Foreign.

<sup>59</sup>Type of tax benefit check boxes on the Form 8886 include: Deductions, Exclusions from gross income, Absence of adjustments to basis, Tax Credits, Capital loss, Nonrecognition of gain, Deferral, Ordinary loss, and Adjustments to basis.

<sup>60</sup>26 C.F.R. § 1.6033-5(a).

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reported than the Form 8886-T. For calendar years 2000 through 2017, IRS received more than 979,900 Form 8886 disclosure reports from taxpayers. Of that number the taxpayer identified a tax-exempt entity as part of the reportable transaction on 32,847 disclosures or 3.4 percent of all Form 8886 reports. A smaller number was identified by tax advisors on Form 8918. For calendar years 2007 through 2018, out of the 16,477 Form 8918 disclosure statements received from tax advisors, 155 submissions identified a tax-exempt entity as part of a reportable transaction.

While detail about the transactions themselves—when they appear in the form narratives—is not readily available from the Form 8886 disclosure databases. IRS’s Research, Applied Analytics and Statistics Division has created an analytic tool for analyzing narrative information that it has tested on the Form 8886. When we performed a test analysis using this tool on the narrative fields on the Form 8886, we identified keywords that may help isolate tax-exempt organization involvement in potentially abusive schemes and ultimately help select returns for more detailed review. This more detailed review is required because transactions reported on the Form 8886 are not necessarily noncompliant.

For our test analysis, we selected certain terms related to known abusive tax schemes involving tax-exempt entities such as “conservation easement” or related to the tax-exempt sector such as “charitable organization” and counted the number of times the terms appeared in the narrative field of 26,632 Form 8886 disclosures made in fiscal year 2017. For example, the term “conservation easement” occurred in the narrative field of 6,767 disclosure forms and the term charitable organization occurred on 17 disclosure forms. Through further searching on terms that might relate to charitable organizations, such as “charity,” “sports,” “children,” “animals,” “foundation,” and “scientific,” we identified 211 occurrences. IRS is not undertaking this type of analysis of taxpayer disclosures, which would expand its ability to identify tax-exempt entities and evaluate their potential involvement with reportable transactions, as discussed later in this report.

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## IRS Has a Variety of Programs Working Collectively to Identify Abusive Schemes Involving Tax-Exempt Entities, but Some

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## Internal Control Weaknesses Exist in Its Approach

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### Various IRS Programs and Offices Identify and Coordinate on Abusive Tax Schemes

IRS operates various programs to identify abusive tax schemes involving tax-exempt entities.<sup>61</sup> Not all of these programs exclusively address abusive tax schemes with tax-exempt entities but nevertheless can provide relevant information on that issue. For example, the Office of Tax Shelter Analysis processes disclosures of reportable transactions, including those related to tax-exempt entities, and the Lead Development Center may collect information about abusive schemes related to tax-exempt entities as part of its role in dealing with abusive tax transactions in general.

As figure 8 illustrates, several of these programs in practice are linked by the Service-wide Compliance Strategy Executive Steering Committee. This committee is responsible for collecting input from the operating divisions (TE/GE, SB/SE, and LB&I), as well as other parts of IRS, about abusive tax schemes that cross divisional responsibilities, including schemes involving tax-exempt entities. The Executive Steering Committee also may make decisions about how to address abusive tax schemes that cross the operating divisions' responsibility. IRS officials said that the operating divisions are individually responsible for monitoring the committee's performance. Therefore, the committee's decisions depend on what information the operating divisions provide. As figure 8 also shows, the operating divisions pass information about abusive schemes among themselves through referrals, making clear communication among the operating divisions critical for IRS in identifying abusive tax schemes.

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<sup>61</sup>Appendix VI lists programs that IRS agreed address abusive tax schemes involving tax-exempt entities and provides brief descriptions of what the programs do.

**Figure 8: Simplified Schematic of How the Internal Revenue Service (IRS) Addresses Abusive Tax Schemes across Its Operating Divisions**



Source: GAO analysis of Internal Revenue Service information. | GAO-19-491

An IRS office that more directly addresses potential abusive schemes with tax-exempt organizations is TE/GE's Compliance Planning and Classification office (CP&C). This office has several responsibilities relating to identifying abusive tax schemes and communicating with other parts of IRS, as well as coordinating with other operating divisions on potential noncompliance. For example, CP&C is responsible for reviewing emerging abusive tax schemes, conducting research, and reviewing suggestions from a computer portal through which staff can raise

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potential issues about compliance. The portal also serves as the foundation to TE/GE's compliance issue identification process.

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## IRS Met Some, but Not All, of the Internal Controls Criteria Relating to How the Agency Identifies Abusive Tax Schemes with Tax-Exempt Entities

We found that IRS maintains a variety of programs to identify tax schemes involving tax exempt entities agency-wide, and these programs together fully met seven of our 10 criteria. Appendix I contains more information about the criteria we used in our analysis and a table that summarizes the results of our analysis. One criterion that IRS fully met was identifying areas of authority. All of the programs we reviewed had documentation showing the responsibilities the program was to fulfill and the roles it was to perform. IRS's programs also fully met the criterion for ensuring competency by having documented procedures for training to enhance staff's responsibilities across the programs we reviewed and met the communication criterion by, for example, having coordination meetings among officials representing the different operating divisions.

In addition, IRS met the criterion for conducting monitoring activities by, for example, having inventory reports on TE/GE's issue submission portal and maintaining a monitoring group over TE/GE's audit plans. Finally, IRS met all three of our fraud-related criteria with programs or procedures that specifically identify fraud, such as TE/GE's Fraud Investigation Unit, or that assist auditors in identifying fraud on returns, such as IRS's Fraud Handbook. Reviewing whether auditors assessed fraud risk is also part of TE/GE's quality review system.

In the following sections, we discuss how IRS did not meet the other three internal control criteria.

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## IRS Has Not Assessed Risks That Tax-Exempt Entities Do Not Properly File Form 8886-T

A relatively low number of tax exempt entities filing Forms 8886-T combined with our analysis of audit data raises questions about whether tax-exempt entities are filing these forms as often as they should. As we discussed above, tax-exempt entities filed only 71 Forms 8886-T over a 12-year period from fiscal year 2004 through 2016, where they listed prohibited transactions. At about the same time, taxpayers in general filed

thousands of Forms 8886 annually where they identified tax-exempt entities as part of their reportable transactions.

In addition, when we compared Form 8886 filings that identified tax-exempt entities as part of the reportable transaction with SB/SE and LB&I audit data, again for the same time period, we found 432 closed cases with tax changes. Although we did not determine whether the subject of these audits was the abusive scheme involving a tax-exempt entity, the result of 432 closed audit cases suggests that tax-exempt entities may be part of more prohibited transactions than those reported on the 71 Form 8886-T filed during the period. The audit cases identified in SB/SE and LB&I data resulted in about \$1.9 billion in tax changes. The average per audit tax change recommended by SB/SE was \$65,143 and by LB&I was \$19 million. A similar analysis could be conducted comparing audit results with data from Form 8918, which is filed by tax advisors.

IRS officials said the disparity between the number of Form 8886 filings and the small number of 8886-T filings has not raised concerns because the legal requirements for tax-exempt entities filing Form 8886-T are narrower than the requirements taxpayers must follow to file Form 8886, as we discussed earlier. However, IRS has not undertaken a risk assessment to test whether this explanation—that the lower number of filings should be expected because the filing requirement is narrower—is valid, which is inconsistent with the internal control standards for risk assessment.

The Office of Tax Shelter Analysis sends Form 8886-T filings it receives to TE/GE, and the Compliance Planning and Classification office reviews these filings, but no documented process exists to determine whether all tax-exempt entities that should file Form 8886-T were filing the form as required. In addition, IRS provided us with no studies investigating the causes and consequences of such a small number of filings.

While IRS has adopted processes to help ensure proper filing for other disclosures, such as Form 8886, it has not extended these to Form 8886-T. In 2011, we recommended that IRS establish a process to periodically check whether Form 8886 filers met their reporting obligations.<sup>62</sup> In response to that recommendation, IRS implemented a new indicator and

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<sup>62</sup>GAO, *Abusive Tax Avoidance Transactions: IRS Needs Better Data to Inform Decisions about Transactions*, [GAO-11-493](#) (Washington, D.C.: May 12, 2011).

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matching process to review whether filers met their obligations. IRS officials told us that similar controls do not exist for 8886-T filings.

TE/GE officials said one way that they ensure forms are filed is through penalties, yet they said they have never assessed the penalty for nonfiling of Form 8886-T. TE/GE officials also said that another way they ensure proper filing is through education and cited such documentation as IRS Publication 557, Tax-Exempt Status for Your Organization. IRS said it provides other information through its website informing charities of their responsibilities.<sup>63</sup>

Despite this education effort, it may still be the case that a lack of knowledge about filing requirements reduces the number of tax-exempt entities that file. An IRS official suggested that charities may not have the financial sophistication to realize that they are involved in a prohibited tax shelter transaction and therefore are required to file a Form 8886-T. Without a better understanding of the reasons behind the low filing, IRS cannot be reasonably certain that tax-exempt entities are following the law on filing Form 8886-T and ensuring tax-exempt entities' compliance.

### IRS Data Do Not Facilitate Some Analysis of Abusive Tax Schemes Involving Tax-Exempt Entities

We were able to use the IRS audit and disclosure data to perform certain analyses on abusive tax schemes with tax-exempt entities for this report, but data deficiencies prevented us from undertaking more complete analysis and hinder management's use of the data. These deficiencies—which are inconsistent with internal control standards for quality information—weaken divisions' ability to identify abusive tax schemes involving tax-exempt entities as well as the Executive Steering Committee's ability to make decisions about how to address abusive tax schemes across divisions and develop compliance strategies.

First, the descriptions of project codes in audit data do not always clearly identify abusive tax schemes across operating divisions. For example, one code LB&I uses to identify abusive transactions in audit data is “domestic tax shelters.” TE/GE uses two codes both titled, “Abusive Tax

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<sup>63</sup>IRS cited <https://www.irs.gov/businesses/corporations/abusive-tax-shelters-and-transactions> and <https://www.irs.gov/charities-non-profits/abusive-tax-avoidance-transactions-involving-tax-exempt-organizations>, which we last accessed May 16, 2019.

Avoidance Transactions,” and SB/SE uses a code titled, “Tax Shelter List Projects.” IRS officials provided no additional documentation on what these codes mean. The lack of specificity hinders analyses of abusive tax schemes involving tax-exempt entities.<sup>64</sup> IRS officials said that they do not keep an overall list of project codes that cover abusive schemes involving tax-exempt entities. This limits their ability to readily assess and manage audits of abusive tax schemes involving tax-exempt entities. However, they did say such a list, which would be effective in certain circumstances or operating divisions, might be possible to produce. Cross-operating division analysis could enhance the Executive Steering Committee’s objective to assess emerging issues and develop policy responses.

Second, we found that there were no project codes consistently identifying abusive schemes involving tax-exempt entities that crossed operating divisions. Instead, IRS officials said each operating division assigned its own project codes that identify abusive tax schemes. Having no uniform way to identify abusive schemes across the operating divisions makes analysis of schemes that overlap with different operating divisions’ responsibilities problematic and inhibits IRS from accomplishing its objectives.

The lack of cross-divisional project codes echoes findings from our 2011 report on abusive tax avoidance transaction data, where we found that some abusive tax avoidance transaction data were reported inconsistently across IRS divisions.<sup>65</sup> We said in that report that without comprehensive or consistent information, IRS does not have the best information to decide how to evaluate the results of its audits. Our recommendation to separately track the tax amounts recommended, assessed, and collected between abusive tax avoidance transaction issues and nonabusive transaction issues remains open because IRS said resource and capability constraints preclude it from capturing information in this way.

Similarly, IRS officials told us it would be costly and logistically prohibitive to create new project codes identifying abusive schemes involving tax-

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<sup>64</sup>Appendix I describes how we worked around these limited descriptions of project codes for our analysis and appendix V shows an alternative method of combining Form 8886 data with audit data. While we are confident in these results, the figures we reported represent the minimum number of cases, as we discussed earlier.

<sup>65</sup>GAO, *Abusive Tax Avoidance Transactions: IRS Needs Better Data to Inform Decisions about Transactions*, [GAO-11-493](#) (Washington, D.C.: May 12, 2011).



exempt entities that crossed divisions. However, as we said in our previous report, tracking audit results for abusive and nonabusive transactions would provide IRS management with the data needed to make more informed decisions about program effectiveness and resource allocation. If, as IRS indicated above, it would be possible to make an overall list of codes, such a list could be used to achieve the same results as adjusting the database system.

#### IRS Does Not Use Available Tools to Identify Abusive Schemes with Tax-Exempt Entities That Cut Across Operating Divisions

Although IRS does not identify some data that would facilitate analysis of abusive tax schemes involving tax-exempt entities spanning the operating divisions, we found evidence that TE/GE's Returns Inventory and Classification System (RICS) could at least partially support analysis and monitoring of audit data across the operating divisions.<sup>66</sup> For example, the RICS user manual states that RICS can access a variety of forms outside of TE/GE's purview, such as Form 1065 and the Form 1120 series tax returns, which typically are handled by SB/SE or LB&I respectively. While TE/GE uses RICS, officials we spoke with at LB&I, for example, were not familiar with RICS' capabilities. TE/GE officials said IRS would have to study whether using RICS in other divisions would generate productive audits.

As we discussed earlier in this report, IRS's Research, Analysis and Statistics office also has developed the capability to analyze narrative information, which it has tested on the Form 8886. However, this analytical tool is not being used operationally to review the Form 8886 or any other disclosure report. Our analysis shows that the tool has the potential to help IRS better search disclosure reports for additional information about transactions that could help IRS identify potentially abusive schemes involving tax-exempt entities.

For example, it can be used to identify keywords in disclosure reports that could help determine whether a tax-exempt entity was a party to a reportable transaction that warrants further investigation for compliance.

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<sup>66</sup>TE/GE uses RICS to examine tax filing compliance for its customers and allows access to tax-filing data. TE/GE also uses RICS to track audit results. Furthermore, since RICS provides PDF versions of tax returns, RICS users can avoid delays in requesting hard copies of returns from service centers.

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However, IRS officials told us they have no plans to use this tool but agreed that it may be beneficial.

IRS officials also told us that TE/GE does not routinely review Form 8886 filings that show tax-exempt entities as being part of the reported transaction because the data are not clear indicators of noncompliance. However, by not using these data for possible leads, IRS may be missing opportunities to identify known abusive schemes, which is inconsistent with internal controls on using quality information. Again, our analysis of the 8886 filings combined with audit results suggests that there is potential for IRS to use the Form 8886 to identify potential noncompliance. Without conducting such an analysis, IRS may be missing opportunities to identify leads on tax-exempt entities in abusive tax schemes.

#### Quality Control over Cross-Operating Division Referrals Is Limited

We previously showed that abusive tax schemes involving tax-exempt entities can involve multiple types of entities that cross IRS's operating divisions' areas of responsibility. We also showed that IRS relies on auditors to refer potentially noncompliant entities involved in an abusive scheme to the responsible operating division. Consequently, IRS needs assurance that auditors' make referrals when appropriate. However, IRS lacks a control to ensure that auditors make referrals correctly. An IRS audit official said that managers are tasked with reviewing auditors' work and identifying referrals that should have been made during case closings. However, there is no documented guidance specifically directing managers to assess whether auditors correctly identified referrals involving abusive tax schemes, reducing assurance that such auditors will make such identifications correctly and route them appropriately. IRS's audit quality review systems, which generally measure how well auditors follow procedures from a random sample of audits, also do not assess whether referrals of abusive schemes involving tax-exempt entities are properly identified and routed. The lack of guidance to ensure auditors make referrals across the operating divisions increases risk that the responsible division will not be alerted to potential noncompliance to make further assessments for enforcement action. Absent specific guidance, there also is increased risk that even when one entity in an abusive tax scheme is audited, other entities in the scheme may go unexamined. This is inconsistent with internal controls standards for control activities.

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## Conclusions

Abusive tax schemes involving tax-exempt entities pose enforcement challenges for IRS, as schemes can cross IRS's operating divisions' areas of responsibility and evolve over time. While IRS has established programs to help identify new abusive schemes, opportunities exist to better ensure that IRS accomplishes its objectives of identifying existing and emerging schemes. In particular, opportunities exist for IRS to improve the quality of its data and how it is using the data it has in managing its programs. Because IRS uses codes to identify abusive schemes that are not consistent across the operating divisions, its efforts to formulate policy across operating divisions may be made more difficult. Also, IRS may not be making the best use of its data by not using existing tools that may be helpful in analyzing data to identify abusive schemes involving tax-exempt entities. Next, IRS has an opportunity to reduce the risk that tax-exempt entities are noncompliant by assessing the number of Form 8886-T filings. Finally, referrals across divisions play an important role in IRS's ability to identify schemes with tax-exempt entities, but IRS's internal control activities over referrals are limited. By taking actions to further strengthen its internal controls, IRS could enhance its efforts to identify and combat abusive tax schemes that involve tax-exempt entities.

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## Recommendations for Executive Action

We are making the following five recommendations to IRS:

The Commissioner of Internal Revenue should undertake a risk assessment of tax-exempt entity Form 8886-T filings. Based on the findings of the risk assessment, IRS should then determine whether steps are needed to increase compliance, such as, for example, through increased outreach to tax-exempt entities or assessment of nonfiling penalties. (Recommendation 1)

The Commissioner of Internal Revenue should link audit data on abusive tax schemes involving tax-exempt entities across operating divisions and use the linked data to assess emerging issues and develop policy responses. (Recommendation 2)

The Commissioner of Internal Revenue should test the ability of the Return Inventory Classification System to facilitate analysis and

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monitoring of audit data across the operating divisions and to support the IRS's enforcement objectives. (Recommendation 3)

The Commissioner of Internal Revenue should use existing data analytic tools to further mine Form 8886 and Form 8918 data, which could be used to find audit leads on tax-exempt entity involvement in potentially abusive tax schemes. (Recommendation 4)

The Commissioner of Internal Revenue should develop guidance to help managers ensure referrals about abusive schemes involving tax-exempt entities are made across operating divisions. This could be accomplished by, for example, adopting specific guidance for audit managers to look for referral accuracy in their reviews of case closings. (Recommendation 5)

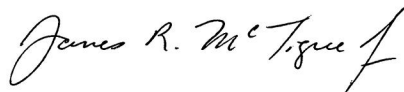
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## Agency Comments

We provided a draft of this report to the Commissioner of Internal Revenue for review and comment. On August 16, 2019, the IRS Deputy Commissioner for Services and Enforcement provided written comments stating that IRS agreed with GAO's recommendations. In the letter, which is reproduced in appendix VII, the Deputy Commissioner said that GAO's recommendations would provide IRS with additional opportunities for improving the identification of tax schemes involving exempt entities. IRS also sent us technical comments, which we incorporated as appropriate.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to the appropriate congressional committees, the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. In addition, this report is available at no charge on the GAO website at <http://www.gao.gov>.

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



James R. McTigue, Jr.  
Director, Tax Issues  
Strategic Issues

# Appendix I: Scope and Methodology

To describe ways in which taxpayers have abused a tax-exempt entity through abusive tax schemes, we conducted interviews with knowledgeable professionals and researchers. We chose the interview sources by reviewing relevant articles from academic databases and reaching out to professional organizations. We narrowed our list of examples of abusive tax schemes by focusing on those professionals and researchers who:

- had recent professional experience as an attorney, accountant, or other industry professional with a firm specializing in tax-exempt entities or tax shelters;
- had recent professional experience in nonprofit management or affiliation with professional associations specializing in nonprofit organization or oversight;
- had published books, articles, or other research on tax-exempt entities or tax shelters within the last 10 years;
- were recommended to us by a relevant professional organization, such as the American Bar Association or the American Institute of Certified Public Accountants;
- work for or previously worked in charity tax enforcement at the state level;
- previously worked for the Internal Revenue Service (IRS), specifically in the Tax Exempt and Government Entities Division (TE/GE); or
- would (in our professional judgment) be able to speak on the topics of abusive tax avoidance schemes or IRS investigations of tax-exempt entities.

We conducted literature and court case reviews using academic and legal databases and covered years 2008 through 2018 using search terms such as “tax avoidance,” “tax-exempt,” and “shelter.” We combined the information found in interviews with reviews of relevant literature and court cases. We categorized the observations from our research by the following criteria.

- Involved federal taxation
- Involved multiple entities, at least one of which was tax exempt, and
- Involved a transaction or scheme already known to IRS, such as a listed transaction or transaction of interest or
- Involved a transaction mentioned in expert interviews.

We then applied the following factors to make the final three choices for the examples: how representative the example was of abusive tax-schemes involving tax-exempt entities; how well-documented we found the example to be in literature reviews; how recent the example had been used by abusers; and how much impact the example had in terms of prevalence and tax revenues.

To examine trends in IRS's compliance and the characteristics of taxpayers audited for using abusive tax schemes involving tax-exempt entities, we collected data from the following IRS business operating divisions that conduct audits on abusive transactions: (1) TE/GE, (2) Small Business/Self-Employed (SB/SE), and (3) Large Business and International (LB&I). We received data extracts from the following computer data systems (1) the Returns Inventory and Classification System data extracts from TE/GE; (2) the Automated Information Management System Centralized Information System (A-CIS), utilized by SB/SE and LB&I; and (3) the Compliance Data Warehouse (CDW) utilized by SB/SE and LB&I.

IRS performs a number of quality control steps to verify the internal consistency of the Return Inventory Classification System, A-CIS, and CDW data. Additionally, we reviewed documentation from the operating divisions on the data, discussed the data with IRS officials, and conducted electronic reliability testing. For example, we verified the completeness of analysis variables and the date ranges for our analysis. We excluded 178 records from our analysis of SB/SE data because they were not within our date range. Based on our review, we believe the data are sufficiently complete and accurate for our purposes.

We identified audits with potential tax exempt entities by selecting audits based on IRS project codes that IRS agreed were relevant to determine the minimum number of audits conducted on abusive schemes involving tax-exempt entities. We also matched the SB/SE and LB&I data with IRS's Form 8886, *Reportable Transaction Disclosure Statement*, data file of the tax-exempt records. We used these data to produce descriptive statistics on audit and taxpayer characteristics and IRS compliance efforts

for 2008 through 2017. Tax return information came from Form 1040, *U.S. Individual Income Tax Return*; Form 1120, *U.S. Corporation Income Tax Return*; and Form 990, *Return of Organization Exempt from Income Tax*. Dollars amounts reported for the 10-year period have been adjusted for inflation in 2018 dollars based on a Fiscal Year, Gross Domestic Product Price index.

Separately, we compiled descriptive statistics on disclosures of reportable transactions that also involved tax-exempt entities from Form 8886 and Form 8918, *Material Advisor Disclosure Statement*. IRS's Office of Tax Shelter Analysis provided the data for Forms 8886 and 8918. We also performed an analysis of the narrative portions of Form 8886 from tax year 2017 to identify more information about the descriptions of the reported transactions. We identified that IRS could conduct Python optical character recognition (OCR) analysis of the text fields on IRS Form 8886. We worked with officials at IRS's Research, Analysis and Statistics office on using Python computer programming language to conduct the analysis.

IRS ran the OCR using keywords associated with 29 different tax-exempt organizations we identified. The keywords we used were based on characteristics of tax-exempt entities, such as "charity" and "foundation"—terms found in 26 U.S.C. Section 501. We received summary tables and copies of PDFs of all Form 8886-T, *Disclosure by Tax-Exempt Entity Regarding Prohibited Tax Shelter Transaction*, for tax years 2004 through 2016. We checked the reliability of IRS's summary tables and manually reviewed the PDF submissions to generate descriptions of the Form 8886-T data.

We conducted reliability testing for all of the data we used for this objective. For the audit and tax return data, we interviewed relevant IRS officials and compared our statistical runs with publicly available statistics. For the Form 8886 and Form 8918 disclosure data, we interviewed relevant IRS officials. For the 8886-T data, we compared the summary tables IRS provided with the PDFs of the original Form 8886-T submissions.

To assess how IRS identifies emerging abusive tax schemes and to identify potential improvements, we reviewed documentation on programs that help IRS identify possible abusive tax schemes involving tax-exempt entities. We identified the programs by reviewing IRS documentation, including the Internal Revenue Manual, in combination with IRS's



determination of relevant programs (see appendix VI for more details about these programs).

We then identified criteria appropriate for assessing the programs' alignment selected principles from *Standards for Internal Control in the Federal Government (Green Book)* and leading practices from our Fraud Risk Management Framework.<sup>1</sup> To select these criteria, we reviewed the *Green Book* and Fraud Risk Management Framework to identify principles relevant to specific aspects of IRS's programs for identifying and initiating enforcement actions against abusive tax schemes involving tax exempt entities. IRS agreed that these criteria were appropriate. The following list shows the criteria we selected through this process.

- Green Book Principle 3: Establish structure, responsibility, and authority
- Green Book Principle 4: Demonstrate a commitment to recruit, develop, and retain competent individuals
- Green Book Principle 7: Identify, analyze, and respond to risks
- Green Book Principle 8: Assess fraud risk
- GAO Fraud Risk Management Framework Overarching Concept 1.2 (structure)
- GAO Fraud Risk Management Framework Overarching Concept 2.1 (plans exist to assess fraud)
- Green Book Principle 10: Design control activities
- Green Book Principle 13: Use quality information
- Green Book Principle 14: Communicate Internally
- Green Book Principle 16: Perform Monitoring Activities

After establishing appropriate criteria, two analysts independently reviewed appropriate evidence and determined whether the evidence aligned with the criteria for the programs was based on the attributes for the *Green Book* criteria and Fraud Risk Management Framework guidance. We also considered how the programs met TE/GE's objective to "promote the highest degree of voluntary compliance with the statutes governing qualification of plans and exemption of certain types of

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<sup>1</sup>[GAO-14-704G](#) and [GAO-15-593SP](#).

organizations from tax and to determine the extent of compliance and the causes of noncompliance with the tax laws by plans and organizations,” and IRS’s objective to “identify new types of tax transactions or promotions that are either abusive or potentially abusive requiring different levels of coordination and varying strategies.” We determined the criterion was met only if all of the programs under review offered sufficient support. Table 1 shows how we assessed the programs we reviewed on the criteria.

**Table 1: How the Internal Revenue Service Performed on GAO’s Assessment Criteria**

<b>Criterion</b>	<b>GAO Assessment</b>
Green Book Principle 3: Establish structure, responsibility and authority	Meets
Green Book Principle 4: Demonstrate a commitment to recruit, develop and retain competent individuals	Meets
Green Book Principle 7: Identify, analyze and respond to risks	Does not meet
Green Book Principle 8: Assess fraud risk	Meets
GAO Fraud Risk Management Framework Overarching Concept 1.2: A structure exists with a dedicated entity to lead fraud risk management activities	Meets
GAO Fraud Risk Management Framework Overarching Concept 2.1: Plans exist to regularly assess fraud risks	Meets
Green Book Principle 10: Design control activities	Does not meet
Green Book Principle 13: Use quality information	Does not meet
Green Book Principle 14: Communicate Internally	Meets
Green Book Principle 16: Perform monitoring activities	Meets

Source: GAO analysis. | GAO-19-491

# Appendix II: Types of Tax-Exempt Organizations Listed in Internal Revenue Code Section 501

The federal tax code provides a variety of tax benefits to organizations often referred to as “tax exempt.” This appendix focuses on organizations or entities qualifying for a tax-exempt status under 26 U.S.C. § 501. We discussed the tax benefits and requirements for different types of tax-exempt organizations in our 2014 report on oversight of charitable organizations.<sup>1</sup> In addition to section 501, there are various other scattered provisions which give a full or partial tax exemption to certain specific types of entities and income.<sup>2</sup>

Section 501 distinguishes between charitable organizations, also known as 501(c)(3) organizations (after the subsection in which they are defined) from all other organizations qualifying for an exemption under section 501. Organizations that qualify for an exemption under section 501, but are not charitable organizations have been referred to as mutual benefit organizations or non-charitable nonprofits. Section 509 further divides charitable organizations between those that are private foundations and all other charitable organizations, and private foundations are divided between operating and nonoperating foundations in section 4942.

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<sup>1</sup>See appendix II in GAO, *Tax-Exempt Organizations: Better Compliance Indicators and Data, and More Collaboration with State Regulators Would Strengthen Oversight of Charitable Organizations*, [GAO-15-164](#) (Washington, D.C.: Dec. 17, 2014).

<sup>2</sup>Certain farmers’ cooperatives, shipowners’ protection and indemnity associations, political organizations, and homeowners associations are wholly or partially tax exempt. 26 U.S.C. §§ 521, 526, 527, 528. Qualified tuition programs established by states (also called 529 plans) and Coverdell education savings accounts are exempt from federal income taxes. 26 U.S.C. §§ 529, 530. Income accruing to possession of the United States and political subdivisions thereof, states and political subdivisions thereof, and the District of Columbia from any essential governmental function or public utility is not included in gross income and therefore not taxed. 26 U.S.C. § 115. Income earned by foreign governments and international organizations from investments in the United States is generally exempt from taxation. 26 U.S.C. § 892.

In addition to charitable organizations, section 501 lists 27 other types of nonprofits, often referred to as mutual benefit organizations, and which include unions, civic leagues, chambers of commerce, credit unions, and veteran organizations, among many others. Certain qualified pension, profit-sharing, and stock bonus plans are also exempt under section 501. Unlike gifts to charitable organizations, gifts to these mutual benefit organizations are not deductible. Mutual benefit organizations are not generally exempt from the federal unemployment tax or the gambling tax, and do not have the additional flexibility in establishing employee retirement plans that is allowed charitable organizations. For a complete list of the types of tax-exempt organizations listed in section 501, including charitable organizations, see below.

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

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**Appendix II: Types of Tax-Exempt  
Organizations Listed in Internal Revenue Code  
Section 501**

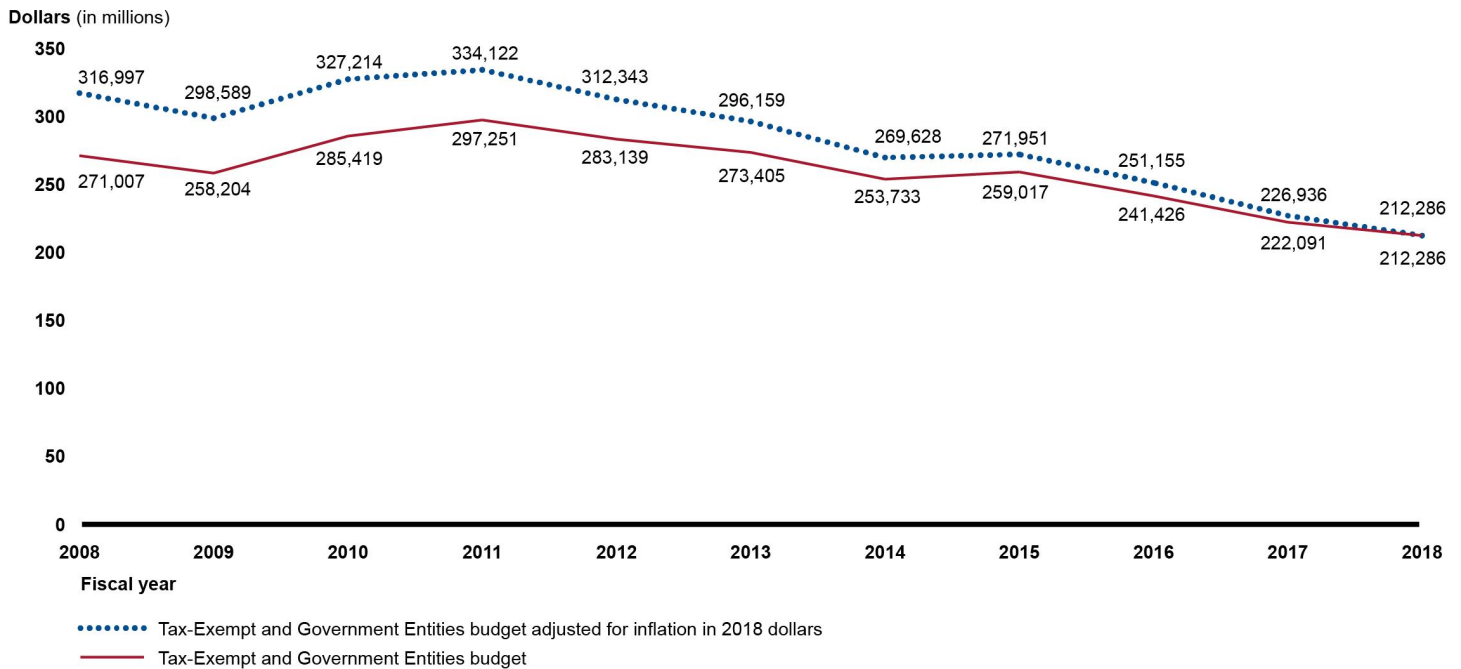
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- Cemetery companies
- Credit unions
- Small mutual insurance companies
- Corporations to finance crop operations
- Supplemental unemployment benefit trusts
- Pre-June 25, 1959, trusts to fund pension benefits
- Veterans' groups
- Black lung benefit trusts
- Multiemployer pension plan trusts
- Armed Forces insurance organizations established before 1880
- Employee Retirement Income Security Act trusts for certain terminated plans
- Multiparent holding companies
- State-sponsored, high-risk insurance organizations
- State-sponsored worker compensation reinsurance organizations
- National railroad retirement investment trust
- Co-op health insurance issuers

# Appendix III: Tax-Exempt and Government Entities Budget over Time

Figure 9 shows the declines in the Internal Revenue Service’s Tax-Exempt and Government Entities Division’s budget since an increase from fiscal years 2009 through 2011.

**Figure 9: Internal Revenue Service Tax-Exempt and Government Entities Budget, Fiscal Years 2008 through 2018, Adjusted for Inflation**



Source: GAO analysis of Internal Revenue Service data. | GAO-19-491

# Appendix IV: Financial Transactions the Internal Revenue Service Requires Taxpayers to Report

The Internal Revenue Service (IRS) defines a transaction as one that includes all the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement, and it includes any series of steps carried out as part of a plan. Department of the Treasury (Treasury) regulations require that certain transactions be registered and that lists of investors be maintained by parties who organize or sell interests in the transaction. A transaction becomes “reportable” (i.e., a taxpayer must disclose it to IRS on Form 8886) when it falls under one or more of the following categories: listed, confidential, contractual protection, loss transactions, and transactions of interest.

- **Listed transactions:** A listed transaction is reportable when it is the same or substantially similar to one of the types of transactions that IRS has determined to be an avoidance transaction.<sup>1</sup> IRS provides a detailed list of the 36 recognized listed transactions on its website.<sup>2</sup>
- **Confidential transactions:** A confidential transaction is offered to a taxpayer or a related party under conditions of confidentiality and is a type of transaction for which a taxpayer has paid a minimum advisor fee.<sup>3</sup> A transaction is considered offered under conditions of confidentiality for two reasons: the advisor places a limitation on the taxpayer’s disclosure of the tax treatment or tax structure of the transaction, and the limitation on disclosure protects the confidentiality of the advisor’s tax strategies. The transaction is treated as confidential even if the conditions of confidentiality are not legally binding on the taxpayer.

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<sup>1</sup>26 U.S.C. § 6011(g); 26 C.F.R. § 1.6011-4(a),(b)(2).

<sup>2</sup>See <https://www.irs.gov/businesses/corporations/listed-transactions>.

<sup>3</sup>A related party as described in 26 U.S.C. §§ 267(b), 707(b).

- **Contractual protection transactions:** A contractual protection transaction is a transaction for which a taxpayer or a related party has the right to full or partial refund of fees if all or part of the tax consequences from the transaction are not sustained.<sup>4</sup> It also includes a transaction for which fees are contingent on a taxpayer's realization of tax benefits from the transaction.
- **Loss transactions:** A loss transaction is a transaction that results in a taxpayer claiming a loss.<sup>5</sup> The type of taxpaying individual or entity determines the applicable amount of the loss. The types of loss transactions IRS has described are as follows for:
  - Individuals: at least \$2 million in any single tax year or \$4 million in any combination of tax years.
  - Corporations (excluding S corporations): at least \$10 million in any single tax year or \$20 million in any combination of tax years.
  - Partnerships with only corporations (excluding S corporations) as partners: at least \$10 million in any single tax year or \$20 million in any combination of tax years, whether or not any losses flow through to one or more partners.
  - All other partnerships and S corporations: At least \$2 million in any single tax year or \$4 million in any combination of tax years, whether or not any losses flow through to one or more partners or stakeholders.
  - Trusts: At least \$2 million in any single tax year or \$4 million in any combination of tax years, whether or not any losses flow through to one or more beneficiaries.<sup>6</sup>
- **Transactions of interest:** A transaction of interest is one that IRS and Treasury believe to have the potential for tax avoidance or evasion, but which lacks enough information for IRS and Treasury to determine whether the transaction should be identified as a tax avoidance transaction.

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<sup>4</sup>26 C.F.R. § 1.6011-4(b)(4).

<sup>5</sup>26 U.S.C. § 165.

<sup>6</sup>If the loss arose from a transaction defined in 26 U.S.C. § 988(c)(1), then the amount is at least \$50,000 for a single tax year (relating to foreign currency transactions) whether or not the loss flows from an S corporation or a partnership.



# Appendix V: Internal Revenue Service Tax Return and Audit Data

Tables 2 and 3 below show Internal Revenue Service (IRS) data for forms filed and audited, and the audit coverage rate, for individual income tax and corporate tax returns during fiscal years 2006 to 2017.<sup>1</sup> Table 4 shows the number of returns processed and audited, and the audit coverage rate, for tax-exempt organizations during fiscal years 2006 to 2015. All three tables show declines in audit coverage rates: the decline occurred for individual income tax returns after fiscal year 2011 and for corporate income tax returns after fiscal year 2012. The audit coverage rate for tax-exempt organizations' returns declined from fiscal years 2013 to 2015, the last fiscal year for which we have complete data on tax-exempt organization returns.

**Table 2: Number and Percentage of Internal Revenue Service (IRS) Audits of Total Individual Income Tax Returns, Fiscal Years 2006 through 2018**

Fiscal Year	Individual Income Tax Returns (Total)		
	Filed	Audited	Audit coverage rate (%)
2006	132,275,830	1,283,950	0.971
2007	134,542,879	1,384,563	1.029
2008	137,849,635	1,391,581	1.009
2009	154,066,773	1,425,888	0.926
2010	142,823,105	1,581,394	1.107
2011	140,837,499	1,564,690	1.111
2012	143,399,737	1,481,966	1.033
2013	145,819,388	1,404,931	0.963
2014	145,236,429	1,242,479	0.855

<sup>1</sup>We define the audit coverage rate as the number of audits closed in the fiscal year for the population (type of organization status), expressed as a percentage of the corresponding number of returns filed in the previous calendar year. For the purposes of this report, we have substituted the original IRS terms “examined” and “examination” with “audited” and “audit(s).”

**Appendix V: Internal Revenue Service Tax Return and Audit Data**

Fiscal Year	Individual Income Tax Returns (Total)		
	Filed	Audited	Audit coverage rate (%)
2015	146,861,217	1,228,117	0.836
2016	147,967,324	1,034,955	0.699
2017	149,919,416	933,785	0.623
2018	150,043,227	892,187	0.595

Source: GAO analysis of IRS data. | GAO-19-491

**Table 3: Number and Percentage of Internal Revenue Service (IRS) Audits of Total Corporate Tax Returns, Fiscal Years 2006 through 2018**

Year	Corporate Tax Returns (Total)		
	Filed	Audited	Audit coverage rate (%)
2006	2,313,812	28,799	1.245
2007	2,256,485	30,004	1.330
2008	2,255,443	30,417	1.349
2009	2,245,168	28,188	1.255
2010	2,143,808	29,803	1.390
2011	2,031,436	30,661	1.509
2012	1,999,266	32,701	1.636
2013	1,957,278	28,235	1.443
2014	1,924,887	25,905	1.346
2015	1,915,337	24,761	1.293
2016	1,887,078	21,136	1.120
2017	1,906,645	18,962	0.995
2018	1,826,883	16,116	0.882

Source: GAO analysis of IRS data. | GAO-19-491

Note: This table does not include Form 1120-S data, a non-taxable return.

**Table 4: Number and Percentage of Internal Revenue Service (IRS) Audits of Total Tax-Exempt Organizations and Related Returns, as Reported by IRS for Fiscal Years 2006 through 2015**

Year	Tax-Exempt Organizations (and Related) Returns (Total)		
	Processed	Audited	Audit coverage rate (%)
2006	849,227	7,079	0.834
2007	867,696	7,580	0.874
2008	888,412	7,861	0.885
2009	823,087	10,187	1.238
2010	776,300	11,449	1.475
2011	858,865	11,699	1.362
2012	798,903	10,743	1.345

**Appendix V: Internal Revenue Service Tax Return and Audit Data**

Year	Tax-Exempt Organizations (and Related) Returns (Total)		
	Processed	Audited	Audit coverage rate (%)
2013	771,675	10,575	1.370
2014	765,395	8,084	1.056
2015	787,339	6,392	0.812

Source: GAO analysis of IRS data. | GAO-19-491

Note: Incomplete data available after fiscal year 2015 prevented us from listing results from fiscal years 2016 to 2018.

**All Abusive Tax Avoidance Transaction Audits**

**Table 5: Number of Abusive Transaction Audits Conducted by the Small Business/Self-Employed (SB/SE) and Large Business and International Divisions (LB&I) for Fiscal Years 2008 through 2017**

Year	SB/SE	LB&I	Total
2008	24,430	2,089	26,519
2009	24,384	1,260	25,644
2010	19,430	1,340	20,770
2011	26,295	1,074	27,369
2012	16,057	740	16,797
2013	13,592	1,115	14,707
2014	6,477	1,111	7,588
2015	5,553	833	6,386
2016	4,578	861	5,439
2017	3,747	501	4,248
<b>Total</b>	<b>144,543</b>	<b>10,924</b>	<b>155,467</b>

Source: GAO analysis of Internal Revenue Service data. | GAO-19-491

**Table 6: Number of Abusive Transaction Audits Conducted by the Tax-Exempt/Government Entities Division (TE/GE) for Fiscal Years 2008 through 2017**

Year	TE/GE		Total
	Returns	Average	
2008	103	\$439,827	\$45,302,171
2009	886	25,581	22,664,571
2010	762	32,407	24,694,055
2011	332	21,054	6,989,927
2012	94	2,226	209,285
2013	34	41,512	1,411,415
2014	38	98,128	3,728,862

**Appendix V: Internal Revenue Service Tax  
Return and Audit Data**

Year	TE/GE		
	Returns	Average	Total
2015	26	44,822	1,165,373
2016	15 or less	N/A	N/A
2017	15 or less	N/A	N/A
<b>Total</b>	<b>2,294</b>	<b>\$46,804</b>	<b>\$107,369,522</b>

Legend: "N/A" means that figures have been suppressed to protect taxpayer information.

Source: GAO analysis of Internal Revenue Service data. | GAO-19-491

Note: Adjusted for inflation in 2018 dollars.

**Table 7: Recommended Tax Change Amount from All Abusive Transactions by the Small Business/Self-Employed (SB/SE) and Large Business and International (LB&I) Divisions for Fiscal Years 2008 through 2017**

Year	Returns (SB/SE)	Average (SB/SE)	Total (SB/SE)	Returns (LB&I)	Average (LB&I)	Total (LB&I)	Total Amount
2008	24,430	\$55,878	\$1,365,089,151	2,089	\$3,598,649	\$7,517,577,088	\$8,882,666,239
2009	24,384	66,582	1,623,546,758	1,260	3,353,249	4,225,093,159	5,848,639,917
2010	19,430	33,438	649,698,145	1,340	4,014,838	5,379,883,114	6,029,581,259
2011	26,295	19,665	517,084,663	1,074	4,734,982	5,085,371,292	5,602,455,955
2012	16,057	28,310	454,581,444	740	5,771,270	4,270,739,355	4,725,320,799
2013	13,592	30,708	417,393,494	1,115	2,058,591	2,295,328,431	2,712,721,926
2014	6,477	26,328	170,528,922	1,111	1,520,675	1,689,469,430	1,859,998,352
2015	5,553	34,107	189,397,121	833	990,695	825,249,654	1,014,646,775
2016	4,578	38,437	175,962,871	861	603,769	519,845,107	695,807,978
2017	3,747	90,452	338,925,762	501	1,729,074	866,265,841	1,205,191,603
<b>Total</b>	<b>144,543</b>	<b>\$40,834</b>	<b>\$5,902,208,330</b>	<b>10,924</b>	<b>\$2,991,104</b>	<b>\$32,674,822,471</b>	<b>\$38,577,030,801</b>

Source: GAO analysis of Internal Revenue Service data. | GAO-19-491

Note: Adjusted for inflation in 2018 dollars.

**Table 8: Hours Spent Auditing All Abusive Transaction Cases Conducted by the Small Business/Self-Employed (SB/SE) and Large Business and International (LB&I) Divisions for Fiscal Years 2008 through 2017**

Year	Returns (SB/SE)	Avg. hours (SB/SE)	Median (SB/SE)	Total hours (SB/SE)	Returns (LB&I)	Avg. hours (LB&I)	Median (LB&I)	Total hours (LB&I)	Total hours
2008	24,430	27.4	10	670,498	2,089	328.5	48	686,178	1,356,676
2009	24,384	25.2	11	613,845	1,260	315.6	37	397,659	1,011,504
2010	19,430	24.2	12	470,814	1,340	387.2	45	518,873	989,687
2011	26,295	18.2	8	478,897	1,074	357.0	54.9	383,432	862,329
2012	16,057	21.0	9	335,784	740	579.5	43	428,800	764,584
2013	13,592	19.1	8	259,612	1,115	245.4	6	273,570	533,182
2014	6,477	23.4	10.3	151,372	1,111	136.5	5.9	151,699	303,071

**Appendix V: Internal Revenue Service Tax Return and Audit Data**

Year	Returns (SB/SE)	Avg. hours (SB/SE)	Median (SB/SE)	Total hours (SB/SE)	Returns (LB&I)	Avg. hours (LB&I)	Median (LB&I)	Total hours (LB&I)	Total hours
2015	5,553	29.6	14.5	164,095	833	111.1	6	92,523	256,618
2016	4,578	35.2	16	160,923	861	120.3	1.5	103,538	264,461
2017	3,747	43.1	20	161,469	501	153.4	21	76,870	238,339
Total	144,543	24	<sup>a</sup>	3,467,309	10,924	285	<sup>a</sup>	3,113,142	6,580,451

Source: GAO analysis of Internal Revenue Service Data. | GAO-19-491

<sup>a</sup>Number not calculated.

**Table 9: Hours Spent Auditing All Abusive Transaction Cases Conducted by the Tax- Exempt/Government Entities (TE/GE) Division for Fiscal Years 2008 through 2017**

Year	Returns (TE/GE)	Avg. Exam time (TE/GE)	Median (TE/GE)	Total hours
2008	103	105	36	10,855
2009	886	57	20	50,760
2010	762	68	23.75	52,142
2011	332	90	21	29,814
2012	94	68	24	6,367
2013	34	68	20	2,243
2014	38	124	35	4,701
2015	26	83	3	2,151
2016	15 or less	119	57	N/A
2017	15 or less	19	9	N/A
<b>Total</b>	<b>2,294</b>	<b>70</b>	<b>22</b>	<b>160,794</b>

Source: GAO analysis of Internal Revenue Service data. | GAO-19-491

Note: "N/A" means that figures have been suppressed to protect taxpayer information.

**Table 10: Number of Abusive Transaction Audits Conducted by the Small Business/Self-Employed (SB/SE) and Large Business and International (LB&I) Divisions Resulting in Tax Changes during Fiscal Years 2008 through 2017**

	SB/SE	LB&I	Total
<b>Change</b>	131,812	9,385	141,197
<b>No-Change</b>	12,731	1,539	14,270
<b>Total</b>	<b>144,543</b>	<b>10,924</b>	<b>155,467</b>

Source: GAO analysis of Internal Revenue Service data. | GAO-19-491

**Table 11: Number of All Abusive Tax Avoidance Transaction Audits Conducted by the Tax- Exempt/Government Entities (TE/GE) Division Resulting in Tax Changes during Fiscal Years 2008 through 2017**

	TE/GE
<b>Change</b>	1,974
<b>No-Change</b>	320
<b>Total</b>	<b>2,294</b>

Source: GAO analysis of Internal Revenue Service data. | GAO-19-491

**Table 12: Total Number of Abusive Transaction Audits Conducted by the Small Business/Self-Employed (SB/SE), Large Business and International (LB&I), and Tax Exempt/Government Entities (TE/GE) by the Type of Return during Fiscal Years 2008 through 2017**

Return Type	SB/SE	LB&I	TE/GE	Total
Form 941, 941PR, 941SS	audited	audited	audited	<b>4,993</b>
Form 1120 series	audited	audited	audited	<b>21,067</b>
Form 720	audited	not audited	not audited	<b>42</b>
Form 1041	audited	audited	audited	<b>1,396</b>
Form 1065	audited	audited	not audited	<b>9,248</b>
Form 8804	not audited	audited	not audited	<b>10 or less</b>
Form 940	audited	not audited	audited	<b>656</b>
Form 943, 943PR	audited	not audited	not audited	<b>39</b>
Form 1042	audited	audited	not audited	<b>10 or less</b>
Form 944	audited	not audited	not audited	<b>19</b>
Form 945	audited	not audited	audited	<b>67</b>
Form 1040, 1040A	audited	audited	not audited	<b>52</b>
Form 1040NR, 1040NREZ, 1041	audited	audited	not audited	<b>21</b>
Form 1040 series	audited	audited	audited	<b>115,956</b>
Form 1120, 1120C, 1120F, 1120FSC, 1120L	audited	audited	audited	<b>333</b>
Form 900C	not audited	audited	not audited	<b>10 or less</b>
Form 990-T	not audited	not audited	audited	<b>57</b>

**Appendix V: Internal Revenue Service Tax Return and Audit Data**

Return Type	SB/SE	LB&I	TE/GE	Total
Form 1965	audited	audited		11
Form 5227	not audited	not audited	audited	10 or less
Form 990-PF	not audited	not audited	audited	127
Form 4720	not audited	not audited	audited	42
Form 709	audited	not audited	not audited	860
Form 706, 706NA, 706A	audited	not audited	not audited	1,103
Form 4720	not audited	not audited	audited	282
Form 990	not audited	not audited	audited	1,371
<b>Total</b>	<b>144,543</b>	<b>10,924</b>	<b>2,294</b>	<b>157,761</b>

Key: “✓” - IRS return types audited by the listed IRS division; “—” - IRS return types not audited.

Source: GAO analysis of Internal Revenue Service data. | GAO-19-491

**Abusive Tax Avoidance Transaction Audits Selected by Project Code Having a Likelihood of Involving a Tax-Exempt Entity**

**Table 13: Number and Percent of Abusive Transaction Audits for Project Codes with a Likelihood of Having an Associated Tax-Exempt Entity Conducted by the Small Business/Self-Employed (SB/SE) and Large Business and International (LB&I) Divisions for Fiscal Years 2008 through 2017**

Year	Number (SB/SE)	Percent of All Audits (SB/SE)	Number (LB&I)	Percent of All Audits (LB&I)	Total
2008	852	0.6	324	3.0	1,176
2009	700	0.5	143	1.3	843
2010	576	0.4	87	0.8	663
2011	354	0.2	85	0.8	439
2012	301	0.2	106	1.0	407
2013	190	0.1	47	0.4	237
2014	62	0.0	29	0.3	91
2015	107	0.1	59	0.5	166
2016	47	0.0	39	0.4	86
2017	55	0.0	44	0.4	99
<b>Total</b>	<b>3,244</b>	<b>2.2</b>	<b>963</b>	<b>8.8</b>	<b>4,207</b>

Source: GAO analysis of Internal Revenue Service data. | GAO-19-491

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**Appendix V: Internal Revenue Service Tax  
Return and Audit Data**

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**Appendix V: Internal Revenue Service Tax  
Return and Audit Data**

**Table 14: Recommended Tax Change Amounts from Abusive Transaction Audits for Project Codes with a Likelihood of Having an Associated Tax-Exempt Entity Conducted by the Small Business/Self-Employed (SB/SE) and Large Business and International (LB&I) Divisions for Fiscal Years 2008 through 2017**

Year	Returns (SB/SE)	Average (SB/SE)	Total (SB/SE)	Returns (LB&I)	Average (LB&I)	Total (LB&I)	Total Amount
2008	852	\$35,551	<b>\$30,289,308</b>	324	\$4,468,179	\$1,447,690,095	<b>\$1,477,979,403</b>
2009	700	53,121	<b>37,184,727</b>	143	4,957,362	708,902,883	<b>746,087,610</b>
2010	576	53,543	<b>30,840,521</b>	87	15,662,073	1,362,600,344	<b>1,393,440,865</b>
2011	354	64,950	<b>22,992,198</b>	85	20,239,317	1,720,341,921	<b>1,743,334,119</b>
2012	301	66,491	<b>20,013,710</b>	106	11,120,432	1,178,765,798	<b>1,198,779,508</b>
2013	190	54,723	<b>10,397,427</b>	47	7,272,609	341,812,591	<b>352,210,019</b>
2014	62	43,522	<b>2,698,354</b>	29	12,102,124	350,961,591	<b>353,659,945</b>
2015	107	80,216	<b>8,583,090</b>	59	6,120,580	361,114,178	<b>369,697,268</b>
2016	47	5,748	<b>270,131</b>	39	7,669,690	299,117,885	<b>299,388,016</b>
2017	55	2,304,353	<b>126,739,430</b>	44	12,612,799	554,963,145	<b>681,702,575</b>
<b>Total</b>	<b>3,244</b>	<b>\$89,399</b>	<b>\$290,008,896</b>	<b>963</b>	<b>\$8,646,179</b>	<b>\$8,326,270,431</b>	<b>\$8,616,279,327</b>

Source: GAO analysis of Internal Revenue Service data. | GAO-19-491

Note: Adjusted for inflation in 2018 dollars.

**Table 15: Hours Spent Auditing Abusive Transactions for Project Codes with a Likelihood of Having an Associated Tax-Exempt Entity by the Small Business/Self-Employed (SB/SE) and Large Business and International (LB&I) Divisions for Fiscal Years 2008 through 2017**

Year	Returns (SB/SE)	Avg. hours (SB/SE)	Med. (SB/SE)	Total hours (SB/SE)	Returns (LB&I)	Avg. hours (LB&I)	Med. (LB&I)	Total hours (LB&I)	Total hours
2008	852	56.1	20	<b>47,808</b>	324	255.3	62	<b>82,708</b>	<b>130,516</b>
2009	700	66.7	29	<b>46,675</b>	143	348.2	51	<b>49,798</b>	<b>96,473</b>
2010	576	58.5	21	<b>33,715</b>	87	1,795	193	<b>156,173</b>	<b>189,888</b>
2011	354	85.8	38	<b>30,389</b>	85	1,152	135	<b>97,939</b>	<b>128,328</b>
2012	301	71.5	34	<b>21,520</b>	106	1,700	325	<b>180,176</b>	<b>201,696</b>
2013	190	71.6	36	<b>13,600</b>	47	1102	74	<b>51,773</b>	<b>65,373</b>
2014	62	80.9	50	<b>5,019</b>	29	709.7	117	<b>20,582</b>	<b>25,601</b>
2015	107	68.3	39	<b>7,309</b>	59	574.0	0	<b>33,864</b>	<b>41,173</b>
2016	47	99.0	41	<b>4,655</b>	39	332.2	110	<b>12,956</b>	<b>17,611</b>
2017	55	138.0	58	<b>7,591</b>	44	324.9	141	<b>14,295</b>	<b>21,886</b>
<b>Total</b>	<b>3,244</b>	<b>67.3</b>	<b>28</b>	<b>218,279</b>	<b>963</b>	<b>727.2</b>	<b>86</b>	<b>700,263</b>	<b>918,542</b>

Source: GAO analysis of Internal Revenue Service data. | GAO-19-491

**Table 16: Number of Abusive Transaction Involving a Tax-Exempt Entity Audits Resulting in Tax Changes during Fiscal Years 2008 through 2017**

	SB/SE	LB&I	Total
<b>Change</b>	2,892	814	3,706
<b>No-Change</b>	-352	149	501
<b>Total</b>	<b>3,244</b>	<b>963</b>	<b>4,207</b>

Source: GAO analysis of Internal Revenue Service data. | GAO-19-491

**Table 17: Number of Abusive Transaction Involving a Tax-Exempt Entity Audits of Individuals by Adjusted Gross Income (AGI) Category during Fiscal Years 2008 through 2017**

AGI Amount	SB/SE (Number of returns)	LB&I (Number of returns)
Negative or Zero AGI	76	43
\$1 under \$5,000	11	10 or less
\$5,000 under \$10,000	14	0
\$10,000 under \$15,000	12	0
\$15,000 under \$20,000	17	10 or less
\$20,000 under \$25,000	20	0
\$25,000 under \$30,000	20	0
\$30,000 under \$35,000	19	0
\$35,000 under \$40,000	31	0
\$40,000 under \$50,000	49	0
\$50,000 under \$75,000	117	10 or less
\$75,000 under \$100,000	130	10 or less
\$100,000 under \$200,000	403	11
\$200,000 under \$500,000	627	19
\$500,000 under \$1,000,000	368	30
\$1,000,000 under \$1,500,000	159	17
\$1,500,000 under \$2,000,000	102	12
\$2,000,000 under \$5,000,000	206	14
\$5,000,000 under \$10,000,000	76	24
\$10,000,000 or more	40	40
<b>Total</b>	<b>2,497</b>	<b>214</b>

Source: GAO analysis of Internal Revenue Service data. | GAO-19-491

**Table 18: Number of Abusive Transaction Involving Tax-Exempt Entity Audits of Businesses by Size of Business Receipts Category during Fiscal Years 2008 through 2017**

<b>Gross Receipts Amount</b>	<b>Number of returns (Large Business and International)</b>
Zero Gross Receipts	505
Under \$25,000	21
\$25,000 under \$100,000	18
\$100,000 under \$250,000	10 or less
\$250,000 under \$500,000	10 or less
\$500,000 under \$1,000,000	10 or less
\$1,000,000 under \$2,500,000	14
\$2,500,000 under \$5,000,000	10 or less
\$5,000,000 under \$10,000,000	10 or less
\$10,000,000 under \$50,000,000	32
\$50,000,000 under \$100,000,000	0
\$100,000,000 under \$250,000,000	0
\$250,000,000 or more	94
<b>Total</b>	<b>710</b>

Source: GAO analysis of Internal Revenue Service data. | GAO-19-491

**Abusive Tax Avoidance Transaction Audits Selected on the Basis of a Match to a Form 8886 Where the Taxpayer Declared a Tax-Exempt Entity**

**Table 19: Number and Percent of Abusive Transaction Audits for a Taxpayer Who Declared a Tax-Exempt Entity Conducted by the Small Business/Self-Employed (SB/SE) and Large Business and International (LB&I) Divisions for Fiscal Years 2008 through 2017**

Year	Number (SB/SE)	Percent of All Audits (SB/SE)	Number (LB&I)	Percent of All Audits (LB&I)
2008	17	.01%	44	.40%
2009	58	.04%	13	.12%
2010	52	.04%	15	.14%
2011	79	.05%	10 or less	N/A
2012	42	.03%	10 or less	N/A
2013	20	.01%	10 or less	N/A
2014	10 or less	N/A	10 or less	N/A
2015	10 or less	N/A	10 or less	N/A
2016	15	.01%	10 or less	N/A
2017	37	.03%	10 or less	N/A
<b>Total</b>	<b>334</b>	<b>.23%</b>	<b>98</b>	<b>.90%</b>

Source: GAO analysis of Internal Revenue Service data. | GAO-19-491

Note: "N/A" means that figures have been suppressed to protect taxpayer information.

**Appendix V: Internal Revenue Service Tax  
Return and Audit Data**

**Table 20: Recommended Tax Change Amounts from Abusive Transaction Audits for a Taxpayer Who Declared a Tax-Exempt Entities Conducted by the Small Business/Self-Employed (SB/SE) and Large Business and International (LB&I) Divisions for Fiscal Years 2008 through 2017**

<b>Year</b>	<b>Returns (SB/SE)</b>	<b>Average (SB/SE)</b>	<b>Total (SB/SE)</b>	<b>Returns (LB&amp;I)</b>	<b>Average (LB&amp;I)</b>	<b>Total (LB&amp;I)</b>	<b>Total Amount</b>
2008	17	\$125,415	<b>\$2,132,054</b>	44	\$19,164,419	<b>\$843,234,415</b>	<b>\$845,366,469</b>
2009	58	68,729	<b>3,986,276</b>	13	230,527	<b>\$2,996,844</b>	<b>\$6,983,120</b>
2010	52	69,230	<b>3,599,959</b>	15	67,265,482	<b>\$1,008,982,229</b>	<b>\$1,012,582,188</b>
2011	79	59,536	<b>4,703,325</b>	10 or less	N/A	<b>N/A</b>	<b>N/A</b>
2012	42	50,168	<b>2,107,028</b>	10 or less	N/A	<b>N/A</b>	<b>N/A</b>
2013	20	18,132	<b>362,641</b>	10 or less	N/A	<b>N/A</b>	<b>N/A</b>
2014	10 or less	N/A	<b>N/A</b>	10 or less	N/A	<b>N/A</b>	<b>N/A</b>
2015	10 or less	N/A	<b>N/A</b>	10 or less	N/A	<b>N/A</b>	<b>N/A</b>
2016	15	92,299	<b>1,384,480</b>	10 or less	N/A	<b>N/A</b>	<b>N/A</b>
2017	37	73,355	<b>2,714,153</b>	10 or less	N/A	<b>N/A</b>	<b>N/A</b>
<b>Total</b>	<b>334</b>	<b>\$65,143</b>	<b>\$21,757,922</b>	<b>98</b>	<b>\$19,091,274</b>	<b>\$1,870,944,820</b>	<b>\$1,892,702,742</b>

Legend: "N/A" means that figures have been suppressed to protect taxpayer information.

Source: GAO analysis of Internal Revenue Service data. | GAO-19-491

Note: Adjusted for inflation in 2018 dollars.

# Appendix VI: Descriptions of Internal Revenue Service Programs Addressing Abusive Schemes with Tax-Exempt Entities

Table 21 lists 10 programs that the Internal Revenue Service (IRS) operates that may identify or conduct enforcement action on abusive tax schemes that involve a tax-exempt entity.

**Table 21: Internal Revenue Service (IRS) Programs that Address Abusive Tax Schemes with Tax-Exempt Entities**

Program	Description
Service-wide Compliance Strategy Executive Steering Committee (SCS ESC)	The SCS ESC serves as the forum to develop a unified cross-divisional approach to compliance strategies needing collaboration.
Small Business/Self-Employed (SB/SE) Lead Development Center (LDC)	The LDC was established to centralize receipt and development of SB/SE abusive transaction promoter leads, conduct research, build promoter cases, and authorize the initiation of promoter investigations in coordination with Counsel, Criminal Investigations, and other operating divisions.
Office of Tax Shelter Analysis (OTSA)	OTSA serves the entire IRS as a centralized clearinghouse for all information related to abusive tax shelter activity and issues of significant compliance risk to tax administration that comes to the attention of the IRS from both internal and external sources. OTSA collects complete and accurate information, timely analyzes the information to identify trends, and disseminates the results to those in the position to take the necessary action. It also administers Form 8886 and Form 8918 submissions. OTSA also may receive Form 8886-T, Disclosure by Tax-Exempt Entity Regarding Prohibited Tax Shelter Transaction, which it refers to the Tax-Exempt and Government Entities division (TE/GE).
TE/GE Compliance, Planning and Classification (CP&C) office	The office administers the compliance strategy development process, which is authorized by a TE/GE board. CP&C conducts processes that identify, research, select, and monitor examination inventory using data analytics. It also maintains a portal through which TE/GE staff may suggest compliance issues.
TE/GE promoter investigations	TE/GE maintains a staff tasked with tracking leads on promoters of abusive tax schemes involving TE/GE subject areas and coordinating with other parts of IRS about the investigations. The group also takes leads from the LDC and screens them for action by TE/GE enforcement.

**Appendix VI: Descriptions of Internal Revenue  
Service Programs Addressing Abusive  
Schemes with Tax-Exempt Entities**

<b>Program</b>	<b>Description</b>
TE/GE Financial Investigations Unit (FIU)	A unit that performs forensic investigations and audits of complex exempt organizations and other related activities. FIU addresses potentially illegal activities including fraud, money laundering, funding terrorism, and other illegal and abusive transactions involving the misuse of charities.
Operational audit activity	Potentially abusive transactions are generally identified, consolidated and elevated as necessary within each IRS operating division. The divisions that may directly audit abusive tax schemes or members of abusive tax schemes with a tax exempt entity include TE/GE, SB/SE, and Large Business and International.
TE/GE Fraud Specialist	The fraud specialist assists with the identification and development of fraud cases and coordinates with other parts of IRS.
TE/GE Knowledge Management Administration	These are topic-specific groups that generally are charged with identifying approaches to meet employees' knowledge needs and answer questions. For example, they promote coordination among other functions for work-plan development, case selection, and other compliance and outreach activities.
TE/GE Division Counsel Support	Division Counsel is the primary counsel contact for TE/GE employees and managers and provides assistance on procedural and technical guidance, which includes support on abusive tax schemes involving tax-exempt entities.

Source: GAO analysis of IRS information. | GAO-19-491

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# Appendix VII: Comments from the Internal Revenue Service





DEPUTY COMMISSIONER

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

August 16, 2019

Mr. James R. McTigue, Jr.  
Director, Tax Policy and Administration, Strategic Issues Team  
United States Government Accountability Office  
441 G Street, NW  
Washington, DC 20548

Dear Mr. McTigue:

Thank you for the opportunity to review the draft report of the Government Accountability Office entitled "*Tax Law Enforcement: IRS Could Better Leverage Existing Data to Identify Abusive Schemes Involving Tax-Exempt Entities*" (GAO-19-491) (Job Code 102606). We appreciate GAO's review of this issue, and your recommendations provide additional opportunities for improving the identification of tax schemes involving exempt entities.

The Internal Revenue Service (IRS) has long worked to combat abusive tax avoidance transactions. As noted in your report, we designated certain syndicated conservation easements as listed transactions in 2016. We are actively examining cases that represent billions of dollars in charitable contribution deductions. These abusive conservation easement syndicate transactions undermine the public's trust in private land conservation and erode the public's confidence in the tax system, and we are committed to fully addressing this and other abuses.

As reflected in our Strategic Plan, the IRS is committed to advancing the use of data to inform decision making and improve operational outcomes, and your report highlights the potential for enhanced use of existing data to support identification of abuse involving tax-exempt entities. The draft report recommends a risk-assessment of under-filing of Form 8886-T, *Disclosure by Tax-Exempt Entity Regarding Prohibited Tax Shelter Transaction*. This form was required by legislation which linked the disclosure to a significant excise tax. As the report says, the filing volume is less than that of Form 8886, *Reportable Transaction Disclosure Statement*, a regulatory disclosure that does not report tax liability. We note that because the forms are legally incomparable, it is unclear if the filing volume of the former could be predicted from that of the latter. Moreover, the general problem of tax under-reporting may be particularly acute with respect to tax shelters, where the filer is by definition a party to a prohibited transaction.

2

While the report acknowledges IRS efforts to educate taxpayers, a knowing party to a prohibited transaction may not wish to disclose. Nonetheless, we agree with the importance of conducting a risk assessment of the Form 8886-T to improve the potential for identifying potential noncompliance.

The report recommends analysis of Form 8886 and similar data, particularly narrative text, to find leads on exempt entity involvement in potentially abusive tax schemes. While word searches may yield imprecise results that require labor-intensive refinement, we will consider other opportunities to mine the data on these forms to better inform workload selection.

The IRS continues to focus on enforcement that is data-driven. At the same time, we are striving to make our databases inter-operable. Nevertheless, improvements to data technology may be significantly affected by the availability of resources and competing priorities.

The IRS remains committed to continuous improvement in tax compliance. Where applicable, we will strengthen our procedures, as in the case of internal referrals of abusive schemes involving tax-exempt entities.

We appreciate the interest in this important topic. If you have questions, please contact me, or a member of your staff may contact Margaret Von Lienen, Director, Exempt Organizations, at (513) 975-6562.

Sincerely,



Kirsten B. Wielobob  
Deputy Commissioner for  
Services and Enforcement

Enclosure

Enclosure

**Recommendation 1:**

The Commissioner of Internal Revenue should undertake a risk-assessment of tax-exempt entity Form 8886-T filings. Based on the findings of the risk assessment, IRS should then determine whether steps are needed to increase compliance, such as, for example through increased outreach to tax-exempt entities or assessment of non-filing penalties.

**Comment:**

The IRS is committed to conducting a risk-assessment of Form 8886-T filings and based on the result will determine whether additional steps are needed to increase compliance.

**Recommendation 2:**

The Commissioner of Internal Revenue should link audit data on abusive tax schemes involving tax-exempt entities across operating divisions and use the linked data to assess emerging issues and develop policy responses.

**Comment:**

The IRS is committed to improving our data systems and will conduct a review to determine the most feasible method of linking data across the operating divisions.

**Recommendation 3:**

The Commissioner of Internal Revenue should test the ability of the Return Inventory Classification System (RICS) to facilitate analysis and monitoring of audit data across the operating divisions and support the IRS's enforcement objectives.

**Comment:**

IRS agrees with the goal of facilitating analysis and monitoring of audit data across operating divisions. We will evaluate the feasibility of this recommendation or an alternative data system for facilitating the analysis of data across the operating divisions.

**Recommendation 4:**

The Commissioner of Internal Revenue should use existing data analytic tools to further mine Form 8886 and Form 8918 data, which could be used to find audit leads on tax-exempt entity involvement in potentially abusive tax schemes.

**Comment:**

The IRS will explore the use of existing data analytic tools to mine data to identify otherwise undiscovered exempt entity involvement in abusive tax schemes.

2

**Recommendation 5:**

The Commissioner of Internal Revenue should develop guidance to help managers ensure referrals about abusive schemes involving tax-exempt entities are made across operating divisions. This could be accomplished by, for example, adopting specific guidance for audit managers to look for referral accuracy in their reviews of case closings.

**Comment:**

The IRS will develop guidance to help managers across operating divisions ensure referrals involving tax-exempt entities are directed to TE/GE.

---

# Appendix VIII: GAO Contact and Staff Acknowledgments

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## GAO Contact

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

---

## Staff Acknowledgments

In addition to the contact named above, Kevin Daly (Assistant Director); Susan Baker; Jehan Chase; Sara Daleski; Steven Flint; Eric Gorman; Gina Hoover; Andrew Howard; Edward Nannenhorn; Kevin Newak; Carolyn Ours; Robert Robinson; Dylan Stagner; and Elwood White made significant contributions to this review.

Also contributing to this report were Toni Gillich; Sarah Gilliland; John Hussey; Jessica Lucas-Judy; Cynthia Saunders; Stewart Small; Rebecca Shea; and Janet Temko-Blinder.

# Appendix IX: Accessible Data

## Data Tables

**Accessible Data for Large Business and International Abusive Transaction Audits, Fiscal Years 2008 through 2017**

Year	LB&I
2008	2,089
2009	1,260
2010	1,340
2011	1,074
2012	740
2013	1,115
2014	1,111
2015	833
2016	861
2017	501
Total	10,924

**Accessible Data for Figure 4: The Number of Abusive-Transaction Audits Performed by Tax-Exempt/Government Entities Division (TE/TG), Fiscal Years 2008 through 2017**

Year	Number of Tax Exempt/Government Entities
2008	103
2009	886
2010	762
2011	332
2012	94
2013	34
2014	38
2015	26
2016	14
2017	Blank
Total	2,294

**Accessible Data for Figure 5: Average Recommended Tax Change Amount for Audits Involving Tax-Exempt Entities by Small Business/Self-Employed and Large Business & International Divisions, Fiscal Years 2008 through 2017**

Year	SB/SE	LB&I
2008	\$35,550.69	\$4,468,179.48
2009	\$53,120.56	\$4,957,362.24
2010	\$53,543.05	\$15,662,072.52
2011	\$64,950.26	\$20,239,316.59
2012	\$66,490.90	\$11,120,432.43
2013	\$54,723.40	\$7,272,608.51
2014	\$43,521.60	\$12,102,124.22
2015	\$80,216.08	\$6,120,579.77
2016	\$5,747.66	\$7,669,689.78
2017	\$2,304,352.94	\$12,612,799.26

**Accessible Data for Figure 6: The Number of Abusive-Transaction Audits Performed by Small Business/Self-Employed and Large Business & International Divisions, Fiscal Years 2008 through 2017**

Year	SB/SE	LB&I
2008	24,430	2,089
2009	24,384	1,260
2010	19,430	1,340
2011	26,295	1,074
2012	16,057	740
2013	13,592	1,115
2014	6,477	1,111
2015	5,553	833
2016	4,578	861
2017	3,747	501
Total	144,543	10,924

**Accessible Data for Figure 7: Average Recommended Tax Change Amount for the Total of All Abusive Transaction Audits by Small Business/Self-Employed and Large Business & International Divisions, Fiscal Years 2008 through 2017**

Year	Small Business and Self Employed	Large Business and International
2008	\$55,877.74	\$3,598,649.00

Year	Small Business and Self Employed	Large Business and International
2009	\$66,582.25	\$3,353,248.92
2010	\$33,438.04	\$4,014,838.30
2011	\$19,665.04	\$4,734,982.30
2012	\$28,309.98	\$5,771,269.72
2013	\$30,708.32	\$2,058,590.51
2014	\$26,328.04	\$1,520,674.78
2015	\$34,107.14	\$990,695.48
2016	\$38,437.05	\$603,769.01
2017	\$90,452.15	\$1,729,073.72

**Accessible Data for Figure 9: Internal Revenue Service Tax-Exempt and Government Entities Budget, Fiscal Years 2008 through 2018, Adjusted for Inflation**

Fiscal Year	TE/GE Appropriations	TE/GE Adjusted for Inflation (2018 Dollars)
2008	\$271,007	\$316,997
2009	\$258,204	\$298,589
2010	\$285,419	\$327,214
2011	\$297,251	\$334,122
2012	\$283,139	\$312,343
2013	\$273,405	\$296,159
2014	\$253,733	\$269,628
2015	\$259,017	\$271,951
2016	\$241,426	\$251,155
2017	\$222,091	\$226,936
2018	\$212,287	\$212,286

## Agency Comment Letter

Accessible Text for Appendix VII Comments from the Internal Revenue Service

Page 1

August 16, 2019



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Deputy Commissioner for Services and Enforcement

Enclosure

Page 3

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#### Page 4

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Comment:

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