

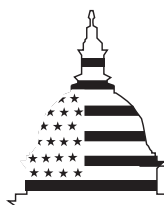
GAO

Report to the Ranking Minority
Member, Subcommittee on Oversight,
Committee on Ways and Means, House
of Representatives

June 2007

TAX COMPLIANCE

Thousands of
Organizations Exempt
from Federal Income
Tax Owe Nearly
\$1 Billion in Payroll
and Other Taxes



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Highlights of [GAO-07-563](#), a report to the Ranking Minority Member, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives

Why GAO Did This Study

As of September 2006, nearly 1.8 million entities were recognized as tax exempt organizations by the Internal Revenue Service (IRS). As such, they do not have to pay federal income taxes. Exempt organizations are still required to remit amounts withheld from employees' wages for federal income tax, Social Security and Medicare, as well as other taxes.

Previous GAO work identified numerous government contractors, Medicare providers, and charities participating in the Combined Federal Campaign (CFC) with billions in unpaid federal taxes. To follow up on the CFC work, the subcommittee requested that GAO determine whether and to what extent (1) exempt organizations have unpaid federal taxes, including payroll taxes; (2) selected case study organizations and their executives are involved in abusive or potentially criminal activity; and (3) exempt organizations with unpaid federal taxes received direct grants from certain federal agencies.

GAO reviewed unpaid taxes and exempt organization data from IRS and selected 25 case studies for audit and investigation. GAO also reviewed data from 3 major grant disbursement systems. GAO referred all 25 cases to IRS for collection activity and criminal investigation, if warranted. In its oral comments on a draft of this report, IRS noted several actions it is taking to enhance exempt organizations' tax compliance.

www.gao.gov/cgi-bin/getrpt?GAO-07-563.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Gregory Kutz at (202) 512-9505 or kutzg@gao.gov.

TAX COMPLIANCE

Thousands of Organizations Exempt from Federal Income Tax Owe Nearly \$1 Billion in Payroll and Other Taxes

What GAO Found

Nearly 55,000 exempt organizations had almost \$1 billion in unpaid federal taxes as of September 30, 2006. About 1,500 of these entities each had over \$100,000 in federal tax debts with some owing tens of millions of dollars. The majority of this debt represented payroll taxes and associated penalties and interest dating as far back as the early 1980s. Willful failure to remit payroll taxes is a felony under U.S. tax law. The \$1 billion figure is understated because some exempt organizations have understated tax liabilities or did not file tax returns.

GAO selected 25 exempt organizations for investigation based primarily on amount of tax debt and number of periods delinquent. For the 25 cases investigated GAO found abusive and potentially criminal activity, including repeated failure to remit payroll taxes withheld from employees. Officials diverted the money to fund their operations, including paying themselves large salaries ranging from hundreds of thousands of dollars to over \$1 million. Many of the 25 case studies accumulated substantial assets, such as million-dollar homes and luxury vehicles. Key officials and employees at 4 exempt organizations were engaged in criminal activities, including attempted bribery of an IRS official and illegal gambling. Despite repeatedly abusing the federal tax system, these entities continued to retain their exempt status. IRS does not have the authority to revoke an organization's exempt status because of unpaid federal taxes.

Examples of Abusive and Potentially Criminal Activity by Exempt Organizations

Type of organization	Tax debt	Organization activity
Health care	Nearly \$30 million	<ul style="list-style-type: none"> Officials are related to several other for-profit entities, all with unpaid federal taxes. Paid millions in management fees to a related entity. Received millions in federal payments.
Industry association	Over \$6 million	<ul style="list-style-type: none"> Paid over 10 key officials salaries in excess of \$100,000 instead of paying payroll taxes. One official built a multimillion-dollar home and purchased luxury vehicles at the same time the exempt organization failed to pay payroll taxes.
Group home/educational institution	Almost \$8 million	<ul style="list-style-type: none"> An official admitted to funding operations, including executive salaries, instead of paying taxes. Operations included large compensation packages to organization officials.

Source: GAO analysis of IRS data and available public records.

Over 1,200 of these exempt organizations with unpaid federal taxes received over \$14 billion in federal grants in fiscal years 2005 and 2006. Six of the 25 exempt organizations GAO investigated received grants; of those 6 entities, 5 appear to have violated the False Statement Act by not disclosing their tax debt as required. For example, one entity that received millions of dollars in grants did not disclose unpaid taxes on multiple applications. Taxpayer privacy statutes prevent granting agencies from verifying an applicant's tax status with IRS unless the taxpayer authorizes such disclosure.

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Abbreviations

ASAP	Automated Standard Application Payment
CFC	Combined Federal Campaign
EO	Exempt Organization
FAADS	Federal Assistance Award Data System
FMS	Financial Management Service
GAPS	Grant Administration and Payment System
HHS	Department of Health and Human Services
IRS	Internal Revenue Service
OASDI	Old Age, Survivors, and Disability Insurance
PMS	Payment Management System
SB/SE	Small Business/Self-Employed
SF	standard form
TE/GE	Tax Exempt and Government Entities Division
TFRP	trust fund recovery penalty
TIN	taxpayer identification number

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United States Government Accountability Office
Washington, DC 20548

June 29, 2007

The Honorable Jim Ramstad
Ranking Minority Member
Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Dear Mr. Ramstad:

The success of our tax system depends on the public's perception of its fairness, including the extent to which taxpayers believe their friends, neighbors, and business competitors are complying with the tax laws and are actually paying their taxes. Unfortunately, a large tax gap—the difference between what taxpayers should pay on a timely basis and what the Internal Revenue Service (IRS) collects through voluntary compliance and enforcement activities—currently exists. This tax gap undermines the credibility of the tax system and costs the federal government billions of dollars in lost revenue. IRS has reported that the estimated annual net tax gap is \$290 billion.¹

Since 2004, we have issued testimonies and reports highlighting government contractors, Medicare providers, and charities participating in the Combined Federal Campaign (CFC) that abused the federal tax system.² In these prior documents, we reported that tens of thousands of contractors, Medicare providers, and CFC charities contributed to the tax gap and undermined the federal tax system by owing billions in unpaid

¹The net tax gap is calculated by subtracting from the gross tax gap amounts IRS expects to recover through enforcement actions and late payments. In 2001 IRS estimated the gross tax gap was \$345 billion, \$55 billion of which IRS estimates it will receive through its collection efforts and late payments.

²GAO, *Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, [GAO-04-95](#) (Washington, D.C.: Feb. 12, 2004); *Financial Management: Thousands of Civilian Agency Contractors Abuse the Federal Tax System with Little Consequence*, [GAO-05-637](#) (Washington, D.C.: June 16, 2005); *Financial Management: Thousands of GSA Contractors Abuse the Federal Tax System*, [GAO-06-492T](#) (Washington, D.C.: Mar. 14, 2006); *Tax Debt: Some Combined Federal Campaign Charities Owe Payroll and Other Federal Taxes*, [GAO-06-755T](#) (Washington, D.C.: May 25, 2006); and *Medicare: Thousands of Medicare Part B Providers Abuse the Federal Tax System*, [GAO-07-587T](#) (Washington, D.C.: Mar. 20, 2007).

federal taxes while at the same time enjoying the benefits of doing business with the federal government or receiving donations from federal employees. Because of the significance of the issues raised in prior work, and most notably our findings that CFC charities, which are exempt from federal income taxes but are still required to pay payroll³ and other taxes, abused the federal tax system, you requested that we perform work to determine whether other organizations exempt from federal income taxes were engaged in similar abuses of the federal tax system.⁴ Specifically, you asked us to determine whether and to what extent (1) exempt organizations have unpaid federal taxes, including payroll taxes; (2) selected case study organizations and their executives are involved in abusive or potentially criminal activity; and (3) exempt organizations with unpaid federal taxes received direct grants from certain federal agencies.

To determine the extent to which exempt organizations have unpaid federal taxes, including payroll taxes, we obtained and analyzed IRS's unpaid tax data as of September 30, 2006. We matched IRS's tax debt data to IRS's database of exempt organizations as of September 30, 2006.⁵ To identify specific instances of abusive and potentially criminal activities by selected exempt organizations and their executives, we performed investigative work on a nonrepresentative selection of 25 exempt organizations. We selected these 25 organizations using primarily the amount of tax debt and number of delinquent tax periods as selection factors. The investigative work included obtaining and analyzing tax, financial, criminal history, and other public records. We also reviewed the statutory authority provided in Internal Revenue Code (I.R.C.) § 501 and interviewed IRS officials on their process for revoking tax exempt status.

³Payroll taxes include employee's income taxes, Social Security and Medicare taxes, and the employer's matching share of Social Security and Medicare withheld from an employee's paycheck. Employers are to collect and remit these taxes to the federal government.

⁴We considered activity to be abusive when an exempt organization's actions (e.g., diversion of payroll tax funds) or inactions (e.g., failure to remit the annual Form 990 return, which is the basis for determining whether an organization continues to meet requirements for exempt status) took advantage of the existing tax enforcement and administration system to avoid fulfilling federal tax obligations and were deficient or improper when compared with behavior that a prudent person would consider reasonable.

⁵To ensure reliability of data in IRS's Unpaid Assessments File and Exempt Organization databases, we considered the results of our IRS financial audit, interviewed IRS officials, performed electronic testing of specific data elements, or a combination of these. See app. I for additional information on our scope and methodology and tests of data reliability.

To determine the extent to which exempt organizations with tax debt received federal grants,⁶ we matched the data set of tax delinquent exempt organizations derived from our first engagement objective to selected agencies' grant disbursement data for fiscal years 2005 and 2006. The grant disbursement data used to conduct this analysis were provided by the Department of Education (Education), the Department of the Treasury's Financial Management Service, and the Department of Health and Human Services (HHS). These three agencies process the majority of federal grants. We reviewed the grant applications of selected exempt organizations with tax debts that received federal grants payments in fiscal years 2005 and 2006 to determine whether they reported federal tax debt as required. We also interviewed grant officials at selected federal agencies on whether they considered tax debts in grant award decision making. See appendix I for further details on our scope and methodology.

We conducted our audit work from August 2006 through March 2007 in accordance with U.S. generally accepted government auditing standards. We performed our investigative work, conducted during the same period, in accordance with standards prescribed by the President's Council on Integrity and Efficiency. We requested comments on a draft of this report from the Commissioner of IRS. We received oral comments from IRS's Tax Exempt and Government Entities Division.

Results in Brief

While most exempt organizations appeared to pay their federal taxes, tens of thousands abused the federal tax system. Our analysis of IRS data shows that nearly 55,000 exempt organizations owed nearly \$1 billion in unpaid payroll and other federal taxes as of September 30, 2006. Seventy-one percent of the unpaid taxes owed by tax exempt organizations consist of payroll taxes and related penalties and interest dating as far back as 1981. Over \$600 million of the nearly \$1 billion is accounted for by about 1,500 exempt organizations that individually owe over \$100,000. Some of these entities owed more than \$10 million in unpaid federal taxes. Further, the nearly \$1 billion in delinquent taxes is understated. We did not include IRS data on tax debts for current periods and disputed debts because they may be routinely resolved or not represent a fully valid tax debt. Further, our estimate understates all types of taxes owed by exempt organizations

⁶For purposes of this audit, grants include formula grants, project grants, and direct payments for specified use as classified by the General Services Administration in the *Catalogue of Federal Domestic Assistance*. We excluded Medicaid from formula grants and Medicare from direct payments for specified use.

because the IRS data used in our analysis do not include debts owed by organizations that did not file federal tax returns or for which IRS has not yet assessed the exact amount of the tax debt.

For all 25 cases that we investigated, we found abusive and potentially criminal activity related to the federal tax system, including failure to remit to IRS payroll taxes withheld from employees. Rather than fulfill their role as “trustees” of this money, these case study entities and their executives diverted the money for other purposes. Willful failure to remit these payroll taxes, which included amounts withheld from employee wages for income taxes, Social Security, and Medicare, is a felony. The failure to properly segregate payroll taxes can be a criminal misdemeanor offense.⁷

We found multiple instances in our case studies where the payroll taxes were diverted to fund operations or to pay hundreds of thousands of dollars in compensation to the organization’s top officials—and in one case, over \$1 million at the same time that the exempt organization owed millions in delinquent taxes. Many of the top officials of selected case study entities owned significant personal assets, including multimillion-dollar homes and luxury vehicles. Other top officials of the exempt organizations in our case studies neglected to remit millions of dollars in delinquent taxes while at the same time paying millions of dollars in management fees to related entities. We also found several instances in which the same individuals who were top officials of the tax exempt entities in our case studies also operated other tax exempt or taxable (for-profit) entities with significant delinquent tax debts. For instance, one of the case study exempt organizations, with over \$10 million in tax debt, was affiliated with several other for-profit entities providing a variety of services from health care to management services that were also delinquent in paying their federal taxes. The related for-profit entities owed more than \$15 million in additional tax debts, primarily payroll taxes. Despite repeatedly abusing the federal tax system, all the exempt organizations in our case studies continued to retain their exempt status. We found that existing federal statutes do not authorize IRS to use tax debt as a cause for revocation of an organization’s exempt status.

⁷I.R.C. § 7202, 7215, and 7512 (b). Organization officials deemed by IRS to be personally liable for the withheld amounts not forwarded are assessed a civil monetary penalty known as a trust fund recovery penalty. I.R.C. § 6672.

We also found that more than 1,200 of the exempt organizations with tax debt received over \$14 billion in direct federal grants in fiscal years 2005 and 2006. This number is substantially understated because our audit did not include all federal agencies and did not cover federal grants disbursed by state or local governments (known as pass-through grants). According to our analysis of the data from the Federal Assistance Award Data System (FAADS), pass-through grants account for about 80 percent of total federal grants. Of our 25 tax exempt case study entities, 6 received federal grants. Our limited audit of grant applications submitted by these 6 case study entities found that 5 of the 6 appear to have violated the False Statement Act⁸ by not disclosing their tax debts in their applications even though they were required to do so. The strict taxpayer privacy statute poses a significant challenge to federal granting agencies in determining the accuracy of representations made by organizations seeking grants. Specifically, federal granting agencies cannot verify an applicant's tax status with IRS unless the taxpayer specifically authorizes such disclosure.⁹ IRS provided oral comments on a draft of this report, outlining planned actions to enhance tax exempt organizations' compliance with tax law.

Background

Section 501(c) of the I.R.C. grants an exemption from federal income taxes to organizations that meet certain requirements.¹⁰ Exempt organization data provided by IRS indicated that nearly 1.8 million organizations in various classifications¹¹ are currently recognized as being tax exempt. Charitable organizations (I.R.C. § 501(c)3)¹² constitute the largest classification, accounting for over 60 percent of all exempt organizations as of September 30, 2006. Other classifications of exempt organization include civic and business leagues, labor organizations, recreational clubs, domestic fraternal societies, and credit unions. Differences between the

⁸18 U.S.C. § 1001.

⁹Federal taxpayers can request or consent to the disclosure of their tax information. I.R.C. § 6103(c).

¹⁰Other sections of the I.R.C. also exempt certain organizations from federal income tax, including sections 501(d), 501(e), and 527.

¹¹See app. III for a list of types of exempt organizations.

¹²This report uses the broad term charitable organization to describe an I.R.C. § 501(c)3 organization. I.R.C. § 501(c)3 also includes religious, scientific, educational, literary, and other organizations.

various classifications include whether donations to the exempt organization are tax deductible and whether the exempt organization has to submit an application to IRS for specific recognition of its tax exempt status. Specifically, donations to certain exempt organizations, such as charitable and religious organizations, certain veteran's organizations, and certain cemetery companies, are deductible on the donor's individual tax return.¹³ Donations to other organizations not specifically recognized as such are not deductible. Organizations that are qualified to receive deductible donations, with the exception of churches, are required to apply to IRS and receive a formal determination of their exempt status.¹⁴ Generally, each exempt organization is required to file an annual informational return¹⁵ that provides IRS with information about the organization and its operations, officers and directors, and whether it is required to obtain specific IRS recognition of its exempt status. An exempt organization's annual information return (Form 990) also provides the public with the primary or sole source of information about the organization.

The determination of exempt status and monitoring of exempt organizations is the responsibility of the Tax Exempt and Government Entities Division (TE/GE) of IRS. The division's responsibilities include accepting applications for and determining whether organizations qualify as exempt under the I.R.C., monitoring exempt organizations for continued compliance with the I.R.C., and when appropriate, revoking the exempt status of an organization that no longer meets requirements for exemption.

Like all other employers, exempt organizations with employees are required to pay payroll taxes that they withhold from employees' wages "in trust" for the federal government, as well as other applicable federal taxes. Payroll taxes withheld from employees consist of income taxes;¹⁶ Old Age, Survivors, and Disability Insurance (OASDI), commonly referred to as Social Security; and Medicare. OASDI is taxed at 6.2 percent on the first

¹³I.R.C. § 170.

¹⁴I.R.C. § 508(a).

¹⁵The annual return exempt organizations are required to file is IRS Form 990, Return of Organization Exempt from Income Tax. Faith-based organizations and exempt organizations with less than \$25,000 in annual revenues are not required to file Form 990.

¹⁶I.R.C. § 3402.

\$94,200 of an employee's salary,¹⁷ and Medicare is taxed at 1.45 percent with no income cap. The employer is also taxed, at the same rate, for OASDI and Medicare on employee wages. To the extent that payroll taxes are withheld and not forwarded to IRS, individuals within the business (e.g., exempt organization officials) may be held personally liable for the withheld amounts not forwarded, and they can be assessed a civil monetary penalty known as a trust fund recovery penalty (TFRP).¹⁸ Willful failure to remit payroll taxes is a felony under U.S. law punishable by a fine, imprisonment, or both, and the failure to properly segregate payroll taxes can be a criminal misdemeanor offense.¹⁹

Within TE/GE, the Exempt Organization (EO) Examinations Office is charged with promoting compliance with the I.R.C. The EO Examinations Office's activities include analyzing the operational and financial activities of exempt organizations and developing other processes to identify areas of noncompliance, developing corrective strategies, and assisting other exempt organization functions in implementing these strategies. In the process of performing the analysis, the EO Examinations Office may assess exempt organizations' payroll or other taxes. If the EO Examinations Office assesses taxes and the taxpayer does not make payment, the matter is referred to IRS's Small Business / Self-Employed (SB/SE) Collections Office. SB/SE Collections Office becomes responsible for collecting the delinquent debt and may use means such as federal tax liens, levies, and seizures, and may assess a TFRP against an organization's officials.

Federal Grants

A federal grant is an award of financial assistance from a federal agency to an organization to carry out an agreed-upon public purpose. As such, federal grants are not used for the direct acquisition of goods or services for the federal government. Based on our analysis of fiscal year 2004 and 2005 data from FAADS, federal agencies collectively awarded grants of approximately \$300 billion annually. Further analysis of the FAADS data indicates that approximately 80 percent of all federal grants are pass-through grants, that is, they are federal grants provided to the state and

¹⁷Tax rates and wage limits are as of 2006. OASDI is taxed at 6.2 percent on the first \$97,500 as of 2007.

¹⁸I.R.C. § 6672.

¹⁹I.R.C. § 7202, 7215, and 7512 (b).

local governments, which, in turn, disburse the grants to the ultimate recipients. Consequently, only about 20 percent of grants are provided directly from the federal government to the organization that ultimately spends the money.

Grant applicants that apply directly to the federal government are required to complete Standard Form (SF) 424. The SF 424 requires grant applicants to certify whether they are delinquent on any federal debt, including federal tax debt.²⁰

Exempt Organizations Had Nearly \$1 Billion in Unpaid Federal Taxes

As of September 2006, nearly 55,000 exempt organizations had nearly \$1 billion in unpaid payroll and other federal taxes. The amount of taxes owed by exempt organizations ranged from \$101 to \$16 million, and the number of delinquent tax periods ranged from a single period to more than 80 tax periods.²¹ However, the dollar amount of federal taxes owed by exempt organizations is understated because some organizations underreport their tax liability or fail to file returns altogether. Further, we excluded certain classifications of exempt organizations, tax debts for current periods, and disputed tax debts.

Characteristics of Unpaid Taxes Owed by Exempt Organizations

As shown in figure 1, about 71 percent of the nearly \$1 billion in unpaid federal taxes comprised payroll taxes and related penalties and interest. About 19 percent, or over \$180 million, related to annual reporting penalties. IRS imposes reporting penalties on entities that fail to file annual returns at all or in a timely manner or that file inaccurate returns.²²

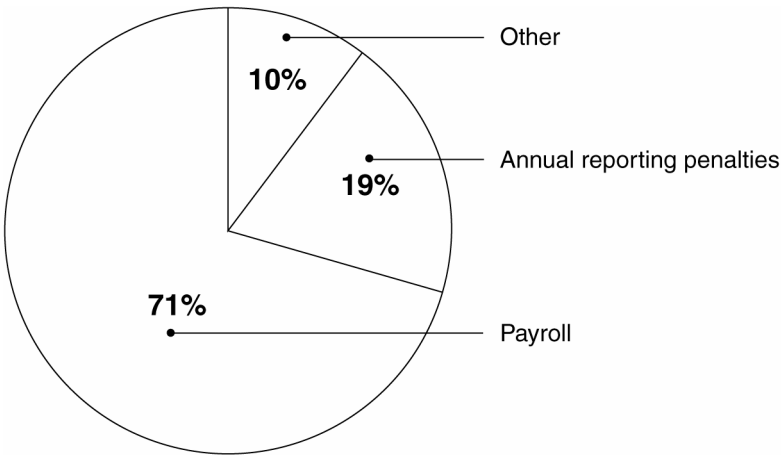
²⁰ All of the SF 424s we reviewed were related to our case investigations and were prescribed by Office of Management and Budget Circular A-102, revised September 2003. Effective October 2005, the SF 424 was revised but continued to include essentially the same question concerning whether the applicant was delinquent on any federal debt.

²¹ A “tax period” varies by tax type. For example, the tax period for payroll and excise taxes is generally one quarter of a year. The taxpayer is required to file quarterly returns with IRS for these types of taxes, although payment of the taxes occurs throughout the quarter. In contrast, for income, corporate, and unemployment taxes, a tax period is 1 year. As described later in this report, a case study consists in some cases of multiple related entities, some or all of which have tax debts. The number of tax periods and the accumulated tax debts we are reporting reflect the accumulated tax periods and tax debts of all related entities.

²² Generally, IRS requires exempt organizations with \$25,000 or more of revenues to file an annual return (i.e., Form 990/990EZ).

The remaining 10 percent of the nearly \$1 billion in delinquent taxes consisted of unrelated business income, excise, and other types of taxes.

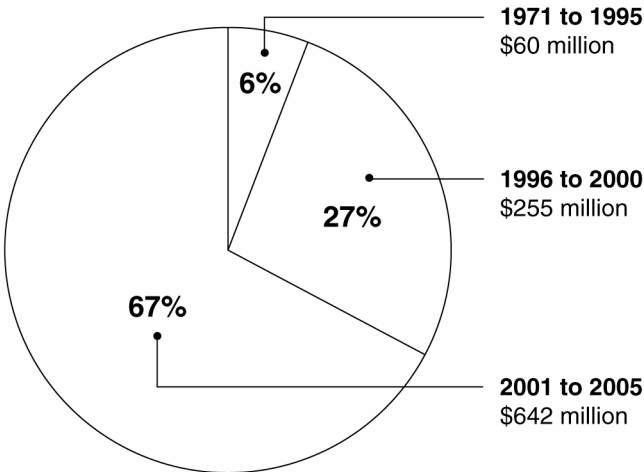
Figure 1: Unpaid Federal Tax Debt of Exempt Organizations by Tax Type



Source: GAO analysis of IRS data as of September 30, 2006.

A significant amount of the unpaid federal taxes by exempt organizations has been outstanding for several years. As reflected in figure 2, while the majority of the nearly \$1 billion in unpaid federal taxes was from tax periods 2001 through 2005, over a quarter of the unpaid taxes are for tax periods prior to 2001.

Figure 2: Age of Federal Tax Debt Owed by Exempt Organizations



Source: GAO analysis of IRS data as of September 30, 2006.

Our previous work has shown that as unpaid taxes age, the likelihood of collecting all or a portion of the amount owed decreases.²³ This is, in part, because of the continued accrual of interest and penalties on the outstanding tax debt. Similarly, tax problems such as the tax gap are aggravated over time if not addressed early on.²⁴

Our analysis of IRS data found that nearly 1,500 of the almost 55,000 delinquent exempt organizations owed in total over \$600 million of the nearly \$1 billion in unpaid federal taxes of exempt organizations we identified. All of these nearly 1,500 exempt organizations owed over \$100,000 each, with some owing more than \$10 million. Another 8,400 owed from \$10,000 to \$100,000 each. Although the largest group—nearly 45,000—owed less than \$10,000 in delinquent taxes, the majority of the debt in this group of exempt organizations is related to payroll taxes withheld from employees and not remitted to the federal government and annual reporting penalties. Further, many exempt organizations in this group repeatedly failed to remit taxes in multiple tax periods.

Amount of Unpaid Federal Taxes Is Understated for Exempt Organizations

Although the nearly \$1 billion in unpaid federal taxes we identified that were owed by exempt organizations as of September 30, 2006, is a significant amount, it understates the full extent of unpaid taxes. This amount does not include amounts due IRS from exempt organizations that did not file payroll taxes (nonfilers) or underreported payroll tax liability (underreporters). Also, we did not include exempt organization tax debt from 2006 tax periods, tax debt for entities owing \$100 or less, or tax debt for certain entities listed in IRS's database of exempt organizations.²⁵

Limiting our ability to more fully estimate the extent of exempt organizations with unpaid federal taxes is the fact that IRS's tax database reflects only the amount of unpaid taxes reported by the exempt organization on a tax return or assessed by IRS through various

²³GAO, *Internal Revenue Service: Recommendations to Improve Financial and Operational Management*, [GAO-01-42](#) (Washington, D.C.: Nov. 17, 2000).

²⁴2006 *Annual Report to the Congress*, the National Taxpayer Advocate.

²⁵IRS's database of exempt organizations contained over 2.5 million entities. IRS does not consider all 2.5 million as currently tax exempt. We only included in our analysis the classifications of exempt organizations that IRS identified as currently tax exempt. This resulted in about 1.8 million entities. See app. I for more details on our scope and methodology.

enforcement programs. IRS's tax database does not reflect amounts owed by exempt organizations that have not filed tax returns and for which IRS has not assessed tax amounts due. Additionally, our analysis did not account for exempt organizations that underreported payroll taxes and had not been identified by IRS. As reported previously²⁶ and as indicated in our case study investigations, some exempt organizations underreported payroll taxes or failed to file returns. IRS estimates that underreporting accounts for more than 80 percent of the gross tax gap.²⁷

We also took a number of steps in determining the amount of tax debt owed by exempt organizations to avoid overestimation. For example, some recently assessed tax debts that appear as unpaid taxes through a matching of IRS unpaid tax and exempt organization records may involve matters that are routinely resolved between the exempt organization and IRS, with the taxes paid, abated,²⁸ or both within a short period. We eliminated these types of debt by including only unpaid federal taxes for tax periods prior to calendar year 2006. Further, we did not include exempt organizations with tax debt of \$100 or less because these small debts likely do not represent abusive behavior. We also eliminated all tax debt IRS identified as not agreed to²⁹ by the exempt organization.

Further, the amount of exempt organization tax debt excludes amounts owed by exempt organizations for which the statutory collection period expired. Generally, there is a 10-year statutory collection period beyond which IRS is prohibited from attempting to collect tax debt.³⁰ Consequently, if exempt organizations owe federal taxes beyond the 10-year statutory collection period, the older tax debt may have been

²⁶[GAO-06-755T](#).

²⁷ According to IRS, nonfilers and those that underpay taxes constitute the rest of the gross tax gap.

²⁸ Abatements are reductions in the amount of taxes owed and can occur for a variety of reasons, such as to correct errors made by IRS or taxpayers or to provide relief from interest and penalties. I.R.C. § 6404.

²⁹ We eliminated from our analysis all tax debt coded by IRS as not having been agreed to by the taxpayer (for example, by filing a balance due return) or a tax court. For financial reporting, those cases are referred to as compliance assessments.

³⁰ The 10-year time may be suspended for a variety of reasons, including for periods during which the taxpayer is involved in a collection due process appeal, litigation, or a pending offer in compromise or installment agreement. As a result, fig. 2 includes taxes that are for tax periods from more than 10 years ago.

removed from IRS's records. We were unable to determine the amount of tax debt that had been removed.

Selected Exempt Organizations Were Involved in Abusive and Potentially Criminal Activity Related to the Federal Tax System

For all 25 cases³¹ involving exempt organizations with delinquent tax debts that we audited and investigated, we found abusive activity, potentially criminal activity, or both related to the federal tax system. These cases reiterate the need for IRS to improve its enforcement of tax laws as previously noted by GAO.³² The amount of unpaid taxes associated with these cases ranged from over \$300,000 to nearly \$30 million. All 25 exempt organizations had unpaid payroll taxes, some dating as far back as the late 1980s. In one instance, an exempt organization had not remitted payroll taxes to IRS for 14 years, thereby accumulating unpaid federal taxes of nearly \$8 million at the time of our audit. Rather than fulfill their role as “trustees” of this money and forward it to IRS as required by law, the officials responsible for these exempt organizations diverted the money to fund the organizations’ operations, which sometimes included millions of dollars in management fees to related entities, or for personal benefits, such as their own salaries. At the time of our audit, IRS had completed TFRP assessments on officials of 15 of the 25 exempt organizations.³³ However, as we have previously reported, collections of TFRP assessments are generally minimal.³⁴ Further, available data show that IRS has taken some collection action and placed liens on the assets of 23 of the 25 entities or their officials. However, IRS initiated actions to seize assets of only 1 of the 25 exempt organizations in our case studies.

Our investigations revealed that despite owing substantial amounts of federal taxes to IRS, top officials of some exempt organizations received substantial salaries—often in the six-figure range and in one case in excess of \$1 million—and had substantial personal assets, including multimillion-dollar homes and luxury cars. Our investigations found that 3 of these

³¹Case includes the exempt organization and, if applicable, any related exempt or for-profit organizations discovered during the audit and investigation. Related parties were determined by the presence of common controlling individuals. Tax debt totals for cases involving related organizations include debt from all the related organizations.

³²GAO, *High-Risk Series, An Update*, [GAO-07-310](#) (Washington, D.C.: Jan. 2007).

³³In addition, IRS records indicate that three other entities are being considered for TFRP assessment. IRS has also completed a TFRP review and decided against assessing a TFRP on one other entity.

³⁴[GAO-04-95](#).

exempt organizations are related to other exempt organizations, for-profit entities, or both that are also tax delinquent. The related entities were primarily discovered because of common top officials. Combined, the 3 exempt organizations and their related entities owed nearly \$40 million in delinquent taxes. Further, 4 of the 25 case study organizations we investigated had key officials and other employees who were convicted of criminal activities, including tax evasion and operating an illegal gambling establishment, at the same time the organizations continued to benefit from a tax exempt status. One entity was fined by a state for employing convicted felons in positions of trust.

Table 1 highlights 10 of the 25 organizations with unpaid taxes that we investigated. Appendix II provides a summary of the other 15 cases we examined. We are referring all 25 cases we examined to IRS for further collection activity and criminal investigation, if warranted.

Table 1: Exempt Organizations with Unpaid Federal Taxes

Case	Nature of work	Unpaid federal tax amount ^a	Comments
1	Health care-related facilities	Nearly \$30 million	<ul style="list-style-type: none"> This case consists of an exempt organization and multiple for-profit related entities with tax debt. The entities owe mostly payroll taxes dating back to the late 1990s. While failing to pay its taxes, <ul style="list-style-type: none"> the exempt organization paid millions of dollars in management fees to a contractor that is listed in public records as an affiliate of the exempt organization and the charity received millions of dollars of its funding from federal government programs. While the entities owed taxes, a top official owned an offshore entity and a residence valued at over \$500,000. Federal, state, and local tax liens were filed against the charity for over \$10 million.
2	Industry association	Over \$6 million	<ul style="list-style-type: none"> Tax debts are mostly payroll taxes dating back to the late 1990s. An officer acknowledged the tax debt and the decision to fund operations, including salaries to over 10 officers in excess of \$100,000, rather than pay the tax liability. During the time the organization incurred payroll tax debt, a top officer owned a multimillion-dollar home and purchased luxury vehicles. IRS assessed a TFRP against one official and placed a tax lien on the organization.

Case	Nature of work	Unpaid federal tax amount ^a	Comments
3	Health care-related facilities	Over \$15 million	<ul style="list-style-type: none"> • Tax debts are mostly payroll taxes dating back to the early 2000s. • At the same time the organization failed to pay its taxes, the top official <ul style="list-style-type: none"> • received more than \$1 million in annual compensation and benefits and • made several hundred thousand dollars in cash transactions at banks and casinos. • Millions in federal tax liens have been placed against the organization, and IRS is in the process of assessing a TFRP.
4	Social club	Over \$1 million	<ul style="list-style-type: none"> • The tax debt, mostly payroll taxes, dates back to the late 1990s. • This organization and former officials pled guilty to conducting an illegal gambling business. • Despite the guilty pleas, the organization continues to operate as an exempt organization. • The organization was also involved in cash transactions not reported to IRS. • To date, a TFRP has not been assessed because IRS concluded that no one could be held liable. • Federal tax liens were filed against the entity.
5	Services to children	Over \$500,000	<ul style="list-style-type: none"> • This organization's tax debt dates back to the late 1980s. • The top official of the organization was convicted of attempting to bribe an IRS employee. • This same official retained a position in the organization, which continues to operate as an exempt organization. • Organization officials allegedly requested that some payments to it be made in cash. • IRS assessed TFRPs against the organization's top officials. • Federal tax liens were filed against the entity.
6	Community services	Nearly \$3 million	<ul style="list-style-type: none"> • Tax debts were mostly payroll taxes dating back to the late 1990s. • The state fined this organization for employing convicted felons in positions of public trust. • An entity employee engaged in criminal activity while employed by the entity. • Although this organization has ceased operations, a similar business has replaced it operating out of the same facility. • Federal tax liens were filed against the entity.
7	Health care-related facilities	Over \$6 million	<ul style="list-style-type: none"> • This case consists of several related entities with tax debt, with related executives that share financial and other operational ties. • Combined, these related entities owe mostly payroll taxes dating back to the late 1990s. • Combined, the entities received over \$20 million annually from government-funded programs. • Several of the exempt organizations appear to pay management fees that total in the millions to a related entity. • Federal tax liens were filed against the entities.

Case	Nature of work	Unpaid federal tax amount ^a	Comments
8	Community services	Over \$1 million	<ul style="list-style-type: none"> Entity officials claim they were unaware they had not paid payroll taxes for several years. Entity officials recently chose to close the entity rather than pay the tax. Entity received nearly \$3 million in federal grants during a recent 2-year period. A top official received compensation of nearly \$100,000. Despite owing taxes, this entity did not declare federal tax debt in its grant application. Federal tax liens were filed against the entity.
9	Group home	Nearly \$8 million	<ul style="list-style-type: none"> Entity owes mostly payroll tax from the early 1990s. A key official knew of the growing tax debt, but the entity chose to fund operations rather than pay the taxes. While incurring the tax debt, key officials owned multimillion-dollar properties. Entity filed for bankruptcy. A TFRP has been assessed against a key official. Federal, state, and local tax liens were filed against the entity for several million dollars.
10	Educational services	Over \$3 million	<ul style="list-style-type: none"> Entity owes mostly payroll taxes dating back to the early 2000s. Despite owing taxes, this entity did not declare federal tax debt in its grant application. The entity received several million dollars in federal grants in a recent year. IRS seized some of the organization's assets in the mid-2000s. A large TFRP has been assessed against several officials. Federal tax liens were filed against the entity.

Source: GAO analysis of IRS data and public and other records.

^aDollar amounts are rounded.

The following provide illustrative detailed information on several of these cases:

Case 1: This exempt organization is related to several for-profit entities that provide health care and other services, all of which have tax debts. The related entities appear to be set up under complex forms of ownership designed to shield income and assets, such as limited liability companies and offshore entities. Combined, these entities owe nearly \$30 million in federal taxes, of which more than \$10 million is attributable to the exempt organization. The exempt organization in particular had not paid federal taxes since the late 1990s, despite receiving millions in federal payments. At the same time, the exempt organization paid millions in management fees to a contractor that, according to available public records, is affiliated with the exempt organization. IRS has not placed a TFRP on any individual with respect to this exempt organization's tax debt.

Case 2: This industry association owes more than \$6 million in tax debt dating back to the late 1990s. A top official of the association admitted that he intentionally failed to remit payroll taxes in order to fund operations, which in a recent year included providing more than 10 officials with six-figure salaries, with one receiving a salary in excess of \$500,000. At the same time, another top officer owned a multimillion-dollar luxury estate and purchased luxury vehicles. IRS has assessed a multimillion-dollar TFRP against an officer of the organization.

Case 3: This health care organization owes more than \$15 million in tax debt dating back to the early 2000s. While not paying its payroll taxes, the organization paid several employees large amounts of annual compensation, including a total compensation package for a top official in excess of \$1 million annually, and several other employees with combined compensation of over \$1 million. The top official also made several hundred thousand dollars in cash transactions at banks and casinos while the organization owed millions in unpaid taxes. Despite holding the organization's top office and earning seven-figure compensation, this official told IRS that he was not responsible for the exempt organization's unpaid taxes.

Case 5: This children's services organization owes more than \$500,000 primarily related to payroll taxes dating back to the late 1980s. The top official of this exempt organization was convicted of attempting to bribe an IRS employee. Other organization employees have criminal records, including records for violent crimes. Further, organization officials allegedly requested that some payments to it be made in cash.

Case 6: This community services organization owes almost \$3 million in tax debt dating from the late 1990s. The organization was fined for employing convicted felons in positions responsible for public safety. In addition, an organization employee was engaged in criminal activity at one of the organization's job sites. To date, IRS has not assessed a TFRP against organization officials. The organization has been replaced by a related entity that is operating out of the same facility. Many of the contracts awarded to the exempt organization have been transferred to this entity.

Despite continuing to abuse the federal tax system, all of the 25 case study organizations continued to retain their tax exempt status. Existing federal statutes do not authorize IRS to revoke exempt status based on an organization's tax delinquency. However, the I.R.C. provides IRS with the authority to approve and monitor exempt organizations and also stipulates

the circumstances under which IRS can revoke an organization's tax exempt status. Specifically, IRS can revoke exempt status when it determines the organization has ceased to operate in a manner consistent with the purpose for which it was granted the tax exempt status. For example, if an organization was granted tax exempt status because it was established to provide employment or other services to underprivileged individuals, and it ceases to do so, IRS can revoke the organization's tax exempt status. In addition, if an organization engages in excess benefit behavior,³⁵ IRS has the authority to assess a tax against the individual who received the benefit. The I.R.C. provides IRS authority to revoke an organization's tax exempt status if it repeatedly engages in excess benefits behavior, including excess compensation.³⁶

However, the I.R.C. does not provide IRS the authority to revoke tax exempt status based on failure to pay taxes. According to IRS officials, organizations whose exempt status is revoked may have delinquent debts, but that was not the criteria for revocation. IRS officials also informed us that revocation is an action of last resort, arrived at after evaluation of many factors and after imposing intermediate sanctions³⁷ to try and correct the problem. Similarly, in cases of excess compensation, IRS generally tried to impose a tax on the individual who received the excess benefits,³⁸ rather than revoke the exempt status of the organization.

³⁵According to I.R.C. § 4958, an excess benefit transaction is any transaction in which an economic benefit is provided by an exempt organization to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.

³⁶IRS does not have a specific dollar value it uses as a benchmark in determining whether compensation is excessive. Rather, IRS considers each circumstance on a case-by-case basis. IRS recently completed a project and issued a report on Exempt Organizations Executive Compensation. See http://www.irs.gov/pub/irs-tege/exec._comp._final.pdf.

³⁷Intermediate sanctions include, for example, levying an excess benefit tax on individuals who have unduly enriched themselves at the expense of an exempt organization. I.R.C. § 4958.

³⁸In early calendar year 2007, IRS reported the results of a study done on exempt organizations' executive compensation. A result of this report was the proposed assessment of excise taxes totaling \$21 million against 40 executives of nonprofit organizations whom it had determined had been paid excessively.

Exempt Organizations with Unpaid Federal Taxes Received Billions in Federal Grant Payments

Based on analysis of limited grant payment data, we found that exempt organizations with unpaid federal taxes received over \$14 billion in direct federal grant payments from three federal agency disbursement systems in fiscal years 2005 and 2006. Grant applicants are required to self-certify on the grant application whether they are delinquent on any federal debt, including federal taxes. Our audit of six case study organizations with delinquent taxes that also received federal grants found that five of the six appear to have violated the False Statements Act³⁹ because they did not declare their delinquent federal taxes on their grant applications.

Tax Delinquent Exempt Organizations Received Billions in Federal Grants

Based on our analysis, we determined that of the nearly 55,000 exempt organizations with federal tax debt, more than 1,200 received over \$14 billion in federal grants from HHS,⁴⁰ Education, the Department of Energy, the National Aeronautics and Space Administration, and other federal agencies in fiscal years 2005 and 2006. The more than 1,200 exempt organizations owed over \$70 million in tax debt yet received substantial amounts in federal grants.

However, our estimate of over \$14 billion in federal grants received by exempt organizations with federal tax debt is likely understated. First, because our analysis was limited to data from the three federal grant payment systems, our analysis did not include all federal grant disbursements. Further, our analysis included only data on direct recipients of federal grant payments, that is, payments provided directly by the federal government to the end user. Based on our analysis of data from FAADS, we estimated that these grants account for only about 20 percent of the total grants awarded by the federal government. The remaining 80 percent of federal grants are provided to states and local governments, which, in turn, disburse them to end users.

³⁹ 18 U.S.C. § 1001.

⁴⁰ The HHS amount excludes Medicaid payments. See app. I for further discussion of the payment databases analyzed.

**Exempt Organizations
with Tax Debt
Misrepresented Their Tax
Status to Granting
Agencies**

Organizations that are applying for federal grants complete SF 424s to provide granting agencies with entity information, such as name, employer identification number, address, and a descriptive title of the project for which the grant will be used. The SF 424 also requires that the grant applicant provide information as to whether the applicant has any delinquent federal debts. The instructions that accompany the SF 424 define federal debt to include taxes owed. The applicant is required to certify that the information provided on the SF 424 is true and correct.

We examined information provided on the SF 424 for six of our case study tax exempt organizations that received grants, all of which had substantial tax debts outstanding. We found that five of the six that received federal grants failed to disclose that they had federal tax debts on the SF 424s filed with the granting agencies. The six entities applied for and received over \$13 million in total grant payments in fiscal years 2005 and 2006. In a recent 3-year time span, one of the exempt organizations we audited applied for multiple grants to provide community services. Even though the entity had an outstanding balance of unpaid federal taxes, the entity did not disclose its tax liability on the SF 424s. The organization subsequently received several million dollars in grant payments during 2 recent fiscal years. Figure 3 provides excerpts of an SF 424 for this organization where the applicant appears to have violated the False Statements Act⁴¹ by not disclosing its delinquent tax debt. Appendix IV contains a copy of the entire SF 424.

⁴¹18 U.S.C. § 1001.

Figure 3: Excerpt of SF 424 Showing Failure to Declare Delinquent Tax Debt

The image shows an excerpt of Standard Form 424, 'Application for Federal Assistance'. The form is divided into several sections. The top section, 'APPLICATION FOR FEDERAL ASSISTANCE', includes fields for 'DATE SUBMITTED', 'DATE RECEIVED BY STATE', 'DATE RECEIVED BY FEDERAL AGENCY', 'State Application Identifier', and 'Federal Identifier'. The 'TYPE OF SUBMISSION' section has checkboxes for 'Construction' and 'Non-Construction', with 'Non-Construction' checked. The 'APPLICANT INFORMATION' section includes 'Legal Name', 'Organizational Unit', 'Address', and 'Name and telephone number of person to be contacted'. The 'EMPLOYER IDENTIFICATION NUMBER (EIN)' and 'TYPE OF APPLICANT' sections are also present. The 'TYPE OF APPLICANT' section has checkboxes for 'A. State', 'B. County', 'H. Independent School Dist.', and 'I. State Controlled Institution of Higher Learning', with 'N' checked. The 'FINANCIAL INFORMATION' section includes 'e. Other', 'f. Program Income', and 'g. TOTAL'. The 'PROGRAM IS NOT COVERED BY E. O. 12372' section has a checked box for 'OR PROGRAM HAS NOT BEEN SELECTED BY STATE FOR REVIEW'. The 'IS THE APPLICANT DELINQUENT ON ANY FEDERAL DEBT?' section has a checked box for 'No'. The 'ASSURANCE' section includes a statement: '18. TO THE BEST OF MY KNOWLEDGE AND BELIEF, ALL DATA IN THIS APPLICATION/PREAPPLICATION ARE TRUE AND CORRECT, THE DOCUMENT HAS BEEN DULY AUTHORIZED BY THE GOVERNING BODY OF THE APPLICANT AND THE APPLICANT WILL COMPLY WITH THE ATTACHED ASSURANCES IF THE ASSISTANCE IS AWARDED.' The 'AUTHORIZED REPRESENTATIVE' section includes 'a. Type Name of Authorized Representative', 'b. Title', 'c. Telephone Number', and 'e. Date Signed'. The form is signed by the 'Executive Director' on [redacted] and dated [redacted]. The form is labeled 'Standard Form 424 (Rev. 7-97)' and 'Previous Edition Usable Authorized for Local Reproduction'.

Copy: A

Applicant provides application information

Applicant attests to having no delinquent federal debt

Applicant attests that information provided is true and correct by signing application

Source: HHS.

We found that while granting agencies can ask prospective grantees for consent to verify federal tax debt information with IRS, granting agencies do so only in a few cases where the grant applicant discloses having federal debts. Agencies do not confirm with IRS the accuracy of applicant information related to federal tax debts because of strict taxpayer privacy laws. Officials at three granting agencies informed us that procedurally, if tax debt is declared on the SF 424, the agencies would request further information to determine if any action needs to be taken. Without accurate debt information, granting agencies are limited in their ability to fully evaluate whether the grantee is a responsible party, the grantee should

receive the grant, additional action needs to be taken, or a combination of these.⁴²

Concluding Observations

The majority of exempt organizations appear to pay their federal taxes. However, our work has shown that tens of thousands of exempt organizations and their officers have taken advantage of the opportunity to avoid paying their federal taxes, in part because IRS does not have the authority to revoke exempt status for failure to pay taxes. In many cases, officers of these delinquent organizations are responsible for diversion of payroll tax money—a felony offense—to pay their substantial salaries and accumulate substantial personal wealth. It is likely that many of these exempt organizations have provided significant and positive services to those in need; but it is also important that they comply with federal tax law. We have referred all 25 of the cases we investigated to IRS for collection and criminal investigation.

Agency Comments and Our Evaluation

We provided a draft of this report to the Commissioner of IRS for review and comment on April 6, 2007. Officials in IRS's TE/GE provided oral comments on the draft on April 24, 2007. The oral comments highlighted several planned actions to enhance exempt organizations' tax compliance efforts. The planned actions cited included analyzing discrepancies between payroll data reported to the Social Security Administration and data reported to IRS, and piloting a new modeling program to identify exempt organizations with a high risk of employment tax noncompliance. In its oral comments, IRS also agreed with the draft report's finding that IRS does not have authority to revoke an organization's exempt status for nonpayment of employment taxes, except under extraordinary circumstances which rarely occur.

IRS planned actions, if implemented effectively, should help IRS avoid additional payroll and other tax compliance issues by exempt organizations. For IRS to ensure that tax exempt organizations comply with tax law it will be important to use the full range of available enforcement tools and hold tax exempt organizations and associated key officials accountable for noncompliance. As discussed in the body of this

⁴²Further actions granting agencies can take include placing restrictions on the funding, requiring that the prospective grantee enter into a payment agreement with IRS, or denying the grant.

report, we identified a number of exempt organizations and their officials that were delinquent in paying significant dollar amounts in federal payroll and other taxes.

As agreed with your office, unless you announce the contents of this report earlier, we will not distribute it until 30 days after its date. At that time, we will send copies to the Secretary of the Treasury, the Commissioner of the Financial Management Service, the Commissioner of Internal Revenue, and interested congressional committees and members. We will also make copies available to others upon request. In addition, this report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

Please contact me at (202) 512-9505 or kutzg@gao.gov if you or your staff have any questions concerning this report. 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 major contributions to this report are listed in appendix V.

Sincerely yours,

A handwritten signature in black ink, reading "Gregory D. Kutz". The signature is fluid and cursive, with the first name "Gregory" being the most prominent part.

Gregory D. Kutz
Managing Director
Forensic Audits and Special Investigations

Appendix I: Objectives, Scope, and Methodology

Our objectives were to determine whether and, if so, to what extent (1) exempt organizations have unpaid federal taxes, including payroll taxes; (2) selected case study organizations and their executives are involved in abusive or potentially criminal activity; and (3) exempt organizations with unpaid federal taxes received direct grants from certain federal agencies.

To determine whether and to what extent exempt organizations have unpaid payroll and other federal taxes, we first identified the population of exempt organizations to be included in our analysis. These organizations include those that either received a formal determination of their exempt status or met basic criteria to be considered exempt. To perform this step, we obtained the exempt organization business master file from the Internal Revenue Service (IRS) as of September 30, 2006. This database contained information on over 2.5 million entities, each with a code indicating the most recent “exempt” status. In consultation with IRS, we identified nearly 1.8 million entities with status codes indicating that they are currently tax exempt.

To identify exempt organizations with unpaid federal taxes, we obtained IRS’s September 30, 2006, unpaid assessments file and matched it to the 1.8 million entities we identified as currently tax exempt using taxpayer identification numbers (TIN). To avoid overstating the amount owed by exempt organizations with unpaid federal tax debts and to capture only significant tax debt, we excluded tax debts meeting specific criteria. The criteria we used to exclude tax debts are as follows:

- tax debts IRS classified as compliance assessments or memo accounts for financial reporting,¹
- tax debts from calendar year 2006 tax periods, and
- exempt organizations with total unpaid taxes of \$100 or less.

The criteria above were used to exclude tax debts that might be under dispute or generally duplicative or invalid and tax debts that are recently incurred. Specifically, compliance assessments or memo accounts were excluded because these taxes have neither been agreed to by the taxpayers nor affirmed by the court, or these taxes could be invalid or

¹Under federal accounting standards, unpaid assessments require taxpayer or court agreements to be considered federal taxes receivable. Compliance assessments and memo accounts are not considered federal taxes receivable because they are not agreed to by the taxpayers or the courts.

duplicative of other taxes already reported. We excluded tax debts from calendar year 2006 tax periods to eliminate tax debt that may involve matters that are routinely resolved between the taxpayers and IRS, with the taxes paid or abated within a short period. We also excluded tax debts of \$100 or less because they are insignificant for the purpose of determining the extent of taxes owed by exempt organizations.

To prepare case studies of selected exempt organizations and their directors or senior officers for abuse of the federal tax system, we selected 25 exempt organizations using a nonrepresentative selection approach based on data-mining results, our judgment, and a number of other criteria, including the amount of unpaid taxes, number of unpaid tax periods, amount of payments reported by IRS, and indications that key officials might be involved in multiple entities with tax debts.

We obtained copies of automated tax transcripts and other tax records (for example, revenue officers' notes) from IRS as of September 30, 2006, and reviewed these records to exclude exempt organizations that had recently paid off their unpaid tax balances and considered other factors before reducing the selection of exempt organizations to 25 case studies. For the selected 25 cases, we performed searches of criminal, financial, and public records. Our investigators contacted several of the exempt organizations and performed interviews.

To determine whether and to what extent exempt organizations with tax debt received federal grants, we obtained and analyzed federal grant payment databases from the Department of Education's (Education) Grant Administration and Payment System (GAPS), the Department of the Treasury Financial Management Service's (FMS) Automated Standard Application Payment system (ASAP), and the Department of Health and Human Services' (HHS) Payment Management System (PMS) for fiscal years 2005 and 2006. These three agencies process grants on behalf of many other federal agencies and, in fiscal years 2005 and 2006, processed the majority of direct and pass-through grants, excluding Medicare and Medicaid. We then matched the grant payment data to the exempt organizations with federal tax debt using the TINs. Of the 25 case studies of exempt organizations with unpaid federal taxes, 6 submitted grant application forms related to grant payments made during fiscal years 2005 and 2006. We requested and reviewed the grant application forms for all 6 entities. We also interviewed officials from HHS, Education, and the Department of Agriculture on whether tax debts are considered in their decisions on whether to provide grants to particular grant applicants.

We conducted our audit work from August 2006 through March 2007 in accordance with U.S. generally accepted government auditing standards, and we performed our investigative work in accordance with standards prescribed by the President's Council on Integrity and Efficiency.

Data Reliability Assessment

For IRS unpaid assessments data, we relied on the work we performed during our annual audits of IRS's financial statements. While our financial statement audits have identified some data reliability problems associated with the coding of some of the fields in IRS's tax records, including errors and delays in recording taxpayer information and payments, we determined that the data were sufficiently reliable to address our report's objectives. Our financial audit procedures, including the reconciliation of the value of unpaid taxes recorded in IRS's master file to IRS's general ledger, identified no material differences.

To help ensure reliability of the exempt organization data, we interviewed IRS officials concerning the reliability of the data provided to us. In addition, we performed electronic testing of specific data elements in the database that we used to perform our work.

For the GAPS, ASAP, and PMS data, we interviewed officials from Education, FMS, and HHS responsible for the databases. In addition, we performed electronic testing of specific data elements that we used to perform our work.

Based on our discussions with agency officials, our review of agency documents, and our own testing, we concluded that the data elements used for this report were sufficiently reliable for our purposes.

We briefed IRS officials on March 27, 2007, on the details of our audit, including our findings and their implications. On April 6, 2007, we requested comments on a draft of this report from the Commissioner of IRS. We received oral comments from the Tax Exempt and Government Entities Division of IRS on April 24, 2007, and have summarized these comments in the Agency Comments and Our Evaluation section of this report.

Appendix II: Exempt Organizations with Unpaid Federal Taxes

Table 1 provides data on 10 detailed case studies. Table 2 provides details of the remaining 15 exempt organizations we selected as case studies. As with the 10 cases discussed in the body of this report, we also found abuse, potential criminal activity, or both related to the federal tax system during our audit and investigations of these 15 case studies. The case studies primarily involved exempt organizations with unpaid payroll taxes, one for as many as 14 years.

Table 2: Exempt Organizations with Unpaid Federal Taxes

Case	Nature of work	Unpaid federal tax amount	Comments
11	Health care facility	Over \$500,000	<ul style="list-style-type: none"> Entity received local funding on the condition that it would be current in paying its payroll taxes. After IRS placed levies on the organization for failing to remit mostly payroll taxes for over 3 years, the entity lost its local funding. While the entity incurred the tax debt, the top official of the entity <ul style="list-style-type: none"> was compensated over \$200,000 by the entity for management services as a sole proprietor, owed the entity nearly \$200,000 for overbudget expenditures and unpaid rents, had the entity's license to operate suspended because of violations of regulations, owed individual income tax, and filed for personal bankruptcy. IRS assessed a trust fund recovery penalty (TFRP) against this top official. Federal and state tax liens have been filed against the entity and this official.
12	Community services	Over \$300,000	<ul style="list-style-type: none"> This entity received over \$2 million in federal grants. Entity pays a \$75,000 annual salary to a relative of the executive director. Despite owing taxes, this entity did not declare federal tax debt in its grant application. A TFRP has not been assessed.
13	Social services	Over \$800,000	<ul style="list-style-type: none"> Entity received nearly \$400,000 in federal grants during a recent 2-year period while owing payroll tax dating back to the early 2000s. Previous top official, responsible for incurring the debt, was convicted of a felony. IRS placed a TFRP on the previous top official. Federal tax liens were filed against the entity.

**Appendix II: Exempt Organizations with
Unpaid Federal Taxes**

Case	Nature of work	Unpaid federal tax amount	Comments
14	Group homes	Over \$3 million	<ul style="list-style-type: none"> • This case consists of multiple exempt organizations with tax debt. These entities owe mostly payroll tax dating back to the late 1990s. • Entities make and receive interest-free loans to other related entities and key officials. • Related key officials are annually compensated over \$300,000 from multiple entities. • One key official owes individual income tax. • Federal tax liens have been filed against some of the related entities and related key officials. • IRS placed a large TFRP on one of the related key officials. • One of the entities entered into multiple installment agreements with IRS and was out of compliance on at least one agreement.
15	Health care-related facility	Nearly \$2 million	<ul style="list-style-type: none"> • Entity has twice filed for bankruptcy, and the top official filed for personal bankruptcy. During this time the entity failed to remit mostly payroll tax dating back to the late 1990s. • IRS assessed TFRPs against key officials who are each compensated over \$100,000 annually. • Federal tax liens have been filed against the entity totaling over \$1 million.
16	Services to children	Over \$1 million	<ul style="list-style-type: none"> • Entity owes mostly payroll tax dating back to the mid-1990s. The top official of this entity is also an official for another for-profit entity with tax debt. • This top official <ul style="list-style-type: none"> • has a history of personal and business bankruptcies; • incurs tax debt, files for bankruptcy, reincorporates as another entity, and incurs additional tax debt; and • runs a separate company that provides services to the exempt organization. The associated costs are significantly greater than those of similar children's services organizations in the same region. • IRS assessed TFRPs against key officials. • Federal tax liens have been filed against the top official.
17	Social services	Over \$1 million	<ul style="list-style-type: none"> • Entity owes mostly payroll taxes dating back to early 2000s. • IRS placed tax liens on this organization. • IRS assessed a TFRP against an organization official.
18	Rehabilitation services	Over \$1 million	<ul style="list-style-type: none"> • Entity accumulated tax debt over several years dating back to the late 1990s. • During this time period, organization officials withdrew several hundred thousand dollars in cash from entity bank accounts. • Related key officials were annually compensated close to \$200,000 in total. • IRS assessed TFRPs against key officials. Some payments have been made, but the majority of the tax remains unpaid. • Federal tax liens have been filed against the entity.
19	Educational services	Over \$1 million	<ul style="list-style-type: none"> • This entity owes mostly payroll tax dating back to the mid-1990s. • A top official owns an expensive home and has recently filed for personal bankruptcy. • IRS assessed a TFRP against organization officials. • Federal tax liens were filed against the entity.

**Appendix II: Exempt Organizations with
Unpaid Federal Taxes**

Case	Nature of work	Unpaid federal tax amount	Comments
20	Services to the elderly	Over \$3 million	<ul style="list-style-type: none"> Entity owes mostly payroll tax for tax periods dating back to the late 1980s. IRS assessed a TFRP against organization officials. Federal tax liens were filed against the entity.
21	Community services	Nearly \$3 million	<ul style="list-style-type: none"> Entity reported on recent financial statements cash and cash equivalents of over several million dollars. At the same time, the entity owed mostly payroll tax dating back to the mid-1990s. While the entity was incurring the tax debt, <ul style="list-style-type: none"> the top official received compensation of over \$250,000 and several other employees received compensation from \$75,000 to \$200,000. A key official owns an expensive home in an exclusive neighborhood and has been investigated or indicted for various violations of civil laws. Federal tax liens have been filed against the entity.
22	Education services	Over \$2 million	<ul style="list-style-type: none"> Entity owes mostly payroll tax dating back to the mid-1990s. In addition, entity owes nontax debt totaling several million dollars. Federal and state tax liens have been filed against the entity. IRS assessed a TFRP against key officials, one of whom also has unpaid federal tax debt dating back to the early 1990s.
23	Children's services	Over \$2 million	<ul style="list-style-type: none"> While failing to remit mostly payroll taxes dating back to the early 2000s, <ul style="list-style-type: none"> entity received over \$2 million in federal grants in recent years, key official received compensation of over \$100,000, and entity entered into multiple payment plans with the IRS and was out of compliance on at least one. Despite owing taxes, this entity did not declare federal tax debt in its grant application. IRS assessed large TFRPs against key officials. Federal tax liens were filed against the entity.
24	Health care services	Over \$5 million	<ul style="list-style-type: none"> Entity owes mostly payroll tax dating back to the early 2000s. Key official received compensation of over \$200,000. IRS has not assessed a TFRP against any individual. Federal tax liens were filed against the entity.
25	Educational services	Over \$300,000	<ul style="list-style-type: none"> Entity received over \$2 million in federal grants during a recent 2-year period while owing mostly payroll tax dating back to the late 1990s. Despite owing taxes, this entity did not declare federal tax debt in its grant application. Entity did not file payroll tax returns for several years, although it made payments for some periods. IRS is considering a request from the entity for an offer in compromise in which the entity would pay only a portion of the unpaid tax debt.

Source: GAO analysis of IRS data and public and other records.

Appendix III: Types of Exempt Organizations

Section 501(c) of the Internal Revenue Code (I.R.C.) lists several types of organizations that qualify for exemption from federal income taxes. The types of exempt organizations are summarized in table 3.

Table 3: Organizations That Qualify for Exemption from Federal Income Taxes

I.R.C. section	Donations deductible to donors	Summary
501(c)1	Yes, if made for exclusively public purposes	Corporations Organized under Act of Congress (including Federal Credit Unions)
501(c)2	No	Title Holding Corporation for Exempt Organization
501(c)3	Yes, generally	Religious, Educational, Charitable, Scientific, Literary, Testing for Public Safety, to Foster National or International Amateur Sports Competition, or Prevention of Cruelty to Children or Animals Organizations
501(c)4	No, generally	Civic Leagues, Social Welfare Organizations, and Local Associations of Employees
501(c)5	No	Labor, Agricultural, and Horticultural Organizations
501(c)6	No	Business Leagues, Chambers of Commerce, Real Estate Boards, Etc.
501(c)7	No	Social and Recreational Clubs
501(c)8	Yes, if for certain § 501(c)3 purposes	Fraternal Beneficiary Societies and Associations
501(c)9	No	Voluntary Employees' Beneficiary Associations
501(c)10	Yes, if for certain § 501(c)3 purposes	Domestic Fraternal Societies and Associations
501(c)11	No	Teachers' Retirement Fund Associations
501(c)12	No	Benevolent Life Insurance Associations, Mutual Ditch or Irrigation Companies, and Mutual or Cooperative Telephone Companies
501(c)13	Yes, generally	Cemetery Companies
501(c)14	No	State-Chartered Credit Unions, Mutual Reserve Funds
501(c)15	No	Mutual Insurance Companies or Associations
501(c)16	No	Cooperative Organizations to Finance Crop Operations
501(c)17	No	Supplemental Unemployment Benefit Trusts
501(c)18	No	Employee-Funded Pension Trust (created before June 25, 1959)
501(c)19	No, generally	Post or Organization of Past or Present Members of the Armed Forces
501(c)21	No	Black Lung Benefit Trusts

I.R.C. section	Donations deductible to donors	Summary
501(c)22	No	Withdrawal Liability Payment Fund
501(c)23	No, generally	Veterans Organization (created before 1880)
501(c)25	No	Title Holding Corporations or Trusts with Multiple Parents
501(c)26	No	State-Sponsored Organizations Providing Health Coverage for High-Risk Individuals
501(c)27	No	State-Sponsored Workers' Compensation Reinsurance Organization
501(c)28	No	National Railroad Retirement Investment Trust

Source: IRS Publication 557.

Appendix IV: OMB Form SF 424 – Application for Federal Assistance

APPLICATION FOR FEDERAL ASSISTANCE		2. DATE SUBMITTED	Applicant Identifier
1. TYPE OF SUBMISSION: Application <input type="checkbox"/> Construction <input type="checkbox"/> Non-Construction		3. DATE RECEIVED BY STATE	State Application Identifier
Pre-application <input type="checkbox"/> Construction <input type="checkbox"/> Non-Construction		4. DATE RECEIVED BY FEDERAL AGENCY	Federal Identifier
5. APPLICANT INFORMATION			
Legal Name:		Organizational Unit:	
Organizational DUNS:		Department:	
Address: Street:		Division:	
City:		Name and telephone number of person to be contacted on matters involving this application (give area code)	
County:		Prefix: First Name:	
State: Zip Code		Middle Name	
Country:		Last Name	
6. EMPLOYER IDENTIFICATION NUMBER (EIN): - - - - -		Suffix:	
8. TYPE OF APPLICATION: <input type="checkbox"/> New <input type="checkbox"/> Continuation <input type="checkbox"/> Revision If Revision, enter appropriate letter(s) in box(es) (See back of form for description of letters.) Other (specify)		Email:	
10. CATALOG OF FEDERAL DOMESTIC ASSISTANCE NUMBER: TITLE (Name of Program): - - - - -		Phone Number (give area code) Fax Number (give area code)	
12. AREAS AFFECTED BY PROJECT (Cities, Counties, States, etc.):		7. TYPE OF APPLICANT: (See back of form for Application Types) Other (specify)	
13. PROPOSED PROJECT Start Date: Ending Date:		9. NAME OF FEDERAL AGENCY:	
15. ESTIMATED FUNDING: a. Federal \$.00 b. Applicant \$.00 c. State \$.00 d. Local \$.00 e. Other \$.00 f. Program Income \$.00 g. TOTAL \$.00		11. DESCRIPTIVE TITLE OF APPLICANT'S PROJECT:	
18. TO THE BEST OF MY KNOWLEDGE AND BELIEF, ALL DATA IN THIS APPLICATION/PREAPPLICATION ARE TRUE AND CORRECT. THE DOCUMENT HAS BEEN DULY AUTHORIZED BY THE GOVERNING BODY OF THE APPLICANT AND THE APPLICANT WILL COMPLY WITH THE ATTACHED ASSURANCES IF THE ASSISTANCE IS AWARDED.		14. CONGRESSIONAL DISTRICTS OF: a. Applicant b. Project	
a. Authorized Representative Prefix First Name Middle Name Last Name Suffix		16. IS APPLICATION SUBJECT TO REVIEW BY STATE EXECUTIVE ORDER 12372 PROCESS? a. Yes. <input type="checkbox"/> THIS PREAPPLICATION/APPLICATION WAS MADE AVAILABLE TO THE STATE EXECUTIVE ORDER 12372 PROCESS FOR REVIEW ON DATE: b. No. <input type="checkbox"/> PROGRAM IS NOT COVERED BY E. O. 12372 <input type="checkbox"/> OR PROGRAM HAS NOT BEEN SELECTED BY STATE FOR REVIEW	
b. Title c. Telephone Number (give area code)		17. IS THE APPLICANT DELINQUENT ON ANY FEDERAL DEBT? <input type="checkbox"/> Yes If "Yes" attach an explanation. <input type="checkbox"/> No	
d. Signature of Authorized Representative e. Date Signed			

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Standard Form 424 (Rev.9-2003)
Prescribed by OMB Circular A-102

Appendix V: GAO Contact and Staff Acknowledgments

GAO Contact

Gregory D. Kutz (202) 512-9505 or kutzg@gao.gov

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In addition to the contact named above, the following individuals made major contributions to this report: Tuyet-Quan Thai, Assistant Director; Gary Bianchi; Ray Bush; Shafee Carnegie; William Cordrey; Jessica Gray; Ken Hill; Aaron Holling; Leslie Jones; Shirley Jones; Jason Kelly; John Kelly; Rick Kusman; Barbara Lewis; Andrew McIntosh; Aaron Piazza; John Ryan; Barry Shillito; and Michael Zola.

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