

# How the IRS Plans to Restructure Its Exempt Organization Operations

The exempt organizations function will have an enhanced position in the structure, but appropriations will still determine if it becomes more effective.

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**P**ublic trust is the charitable sector's most important asset, and one important factor in that trust is effective IRS administration of the federal tax rules designed to ensure that charitable organizations operate exclusively for charitable purposes. In recent years, declining resources and the departure of many senior exempt organizations staff have badly undermined the Service's exempt organizations function, as reflected most dramatically in a sharp decline in published guidance on exempt organizations issues. Fortunately, the current top-to-bottom restructuring of the IRS provides an important opportunity to reverse this trend. While important "design" issues remain to be addressed, the overall framework promises to provide a more effective administrative structure and higher priority for

the Service's administration of the exempt organization rules. As discussed below, however, this restructuring must also be accompanied by a significant increase in funding for exempt organization administration if it is to realize its potential and restore effective IRS oversight of exempt organizations.

## EP/EO

Before 1974, no one specific office in the IRS had primary responsibility for overseeing employee plans and exempt organizations. This raised concern in Congress that the level of resources devoted by the IRS to exempt organization oversight was not adequate. As part of the Employee Retirement Income Security Act of 1974 (ERISA), Congress therefore enacted Section 7802(b), creating the Office of Employee Plans and Exempt Organizations (EP/EO) under the direction of an Assistant Commissioner.

In creating EP/EO, Congress explicitly acknowledged that the regulatory oversight responsibilities delegated to the office differed from the Service's core revenue col-

lection and enforcement functions. Recognizing this difference, Congress expressed concern that the IRS was subordinating its efforts to conduct oversight activities with respect to employee plans and exempt organizations to its efforts to collect revenues.<sup>1</sup> Therefore, ERISA also authorized funding for the EP/EO office, tying the funding level to the total collected from the Section 4940 excise tax on private foundation net investment income.<sup>2</sup> That funding mechanism was never implemented, however, and the EP/EO budget has always been part of the overall IRS appropriation.

Today, the Assistant Commissioner for EP/EO oversees both National Office headquarters activities and the activities of five key district offices (KDOs) relating to tax-exempt entities. The headquarters of EP/EO includes the Employee Plans Division, the Exempt Organizations Division, and the Field Services Branch.<sup>3</sup> The KDO located in Cincinnati has recently become the centralized site for processing exemption determination letters for both exempt organizations and employee plans. Exam-

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ination jurisdiction is vested in the other four KDOs—Northeast (Brooklyn), Southeast (Baltimore), Midstates (Dallas), and Western (Los Angeles). Although programmatic authority over the field rests in the EP/EO Assistant Com-

missioner, there is no direct line authority. Therefore, the district directors of the KDOs rather than the National Office initiate and oversee the day-to-day conduct of examinations, limiting the ability of the National Office to set priorities and ensure consistent interpretation of the applicable tax laws.<sup>4</sup> Until recently, processing of exempt organization returns was divided among all ten of the IRS Service Centers, but it is now centralized at the Ogden, Utah, Service Center.<sup>5</sup>

#### **The growth of the tax-exempt sector.**

Since 1974, the responsibilities of

the Exempt Organizations Division have grown dramatically, due both to the significantly greater number of entities and to the increasing demands their needs place on the system. In 1974, for example, there were approximately 690,000 tax-exempt organizations (excluding churches). By the end of 1996, that number had grown to approximately 1,280,000, nearly double the 1974 figure. These organizations, plus over 266,000 churches, controlled \$1.9 trillion in assets and annual revenues of almost \$900 billion, or more than 10% of the nation's gross domestic product.<sup>6</sup>

As impressive as these numbers are, they only begin to suggest the variety and complexity of the exempt organizations universe. Only about half of these organizations (not including churches) are charitable organizations described in Section 501(c)(3). The remainder are social welfare organizations, labor unions, business leagues, social and recreation clubs, and organizations in the other Section 501 categories.<sup>7</sup> The charitable organizations themselves range from

small community-based organizations run by volunteers to multi-billion dollar hospitals, universities, and private foundations. Their causes include international evangelism, providing direct health and educational services, environmental preservation, and promoting amateur sports. In other words, the Exempt Organizations Division faces the challenge of regulating a sector that is not only growing rapidly but that includes a huge and ever-increasing variety of organizations.

**Funding and staff levels.** From fiscal years 1970 through 1995, the overall IRS budget grew much faster than the economy. On average, the inflation-adjusted growth rate of the IRS budget during the 1970s, 1980s, and early 1990s was at least one full percentage point greater than the real rate of growth of the gross domestic product.<sup>8</sup> Starting in the mid-1990s, however, the budget began shrinking in the face of withering congressional criticism of the IRS.

For fiscal 1996, the IRS appro-

<sup>1</sup> S. Rep't No. 93-383, 93d Cong., 1st Sess. 107-08 (1973); H. Rep't No. 93-779, 93d Cong., 2d Sess. 102-03 (1974). See also Staff of the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1998* (Blue Book), page 29 (hereinafter, "1998 Blue Book"); Staff of the Joint Committee on Taxation, *Description and Analysis of Proposals Relating to the Recommendations of the National Commission on Restructuring the Internal Revenue Service S. 1096 and H.R. 2676 as passed by the House*, page 65 (JCS-1-98) (hereinafter "1998 Joint Committee Report").

<sup>2</sup> Employee Retirement Income Security Act of 1974, P.L. 93-406, 9/2/74, section 1052, 88 Stat. 829. This authorization was later codified at Section 7802(b)(2) of the Code. As discussed below, the Internal Revenue Service Restructuring and Reform Act of 1998, P.L. 105-206, 7/22/98, 112 Stat. 685 (hereinafter "Restructuring Act") repealed Sections 7802(b)(1) and 7802(b)(2).

<sup>3</sup> 1998 Joint Committee Report, pages 9-10. The Employee Plans Division has primary responsibility relating to the federal income tax qualification of employee plans and related trusts, the tax treatment of employees participating in such plans and their beneficiaries, and deductions for employer contributions to plans. The Exempt Organizations Division has primary responsibility relating to tax-exempt organizations, including unrelated business income tax rules and Section 527 political organizations, and, as of 1993, responsibility for the administration of IRS activities with respect to tax-exempt bonds.

<sup>4</sup> 1998 Joint Committee Report, page 12; see also American Bar Association Section of Taxation Committee on Exempt Organizations, "White Paper," reprinted in 10 Exempt Org. Tax Rev 74 (July 1994) (hereinafter "1994 ABA White Paper"), discussing the problems created by this lack of line authority.

<sup>5</sup> See Ann. 96-63, 1996-29 IRB 18.

<sup>6</sup> See "Soaring Assets and Revenues May Invite Look by Congress," VI The Chronicle of Philanthropy 39 (12/3/98); 1998 Joint Committee Report, page 13. The 1998 Joint Committee Report reported assets of only \$1.1 trillion, but more recently Marcus Owens, Director of the IRS Exempt Organizations Technical Division, stated that soon-to-be-released IRS figures place the amount of assets at \$1.9 billion as of 1995, and data collected by the National Center for Charitable Statistics of the Urban Institute confirms the \$1.9 billion figure.

<sup>7</sup> Department of the Treasury, *Internal Revenue Service Data Book* 25 (1996) (hereinafter "1996 IRS Data Book").

<sup>8</sup> See "Perspective on the IRS Budget," 71 Tax Notes 1720 (6/24/96).

priation dropped to \$7.35 billion; down from \$7.48 billion for fiscal 1995 and approximately \$850 million less than what the Administration had requested.<sup>9</sup> For fiscal 1997, the IRS appropriation declined to \$7.2 billion, approximately \$800 million less than the Administration request.<sup>10</sup> For fiscal 1998, the IRS appropriation rose to \$7.8 billion, essentially matching the Administration's request.<sup>11</sup> For fiscal 1999, the Administration requested a total of \$8.3 billion for the IRS, an increase of \$500 million over fiscal 1998,<sup>12</sup> but Congress actually appropriated \$7.9 billion, only a slight increase over fiscal 1998.<sup>13</sup>

The funding of the EP/EO Office has reflected the general financial fortunes of the IRS, with the EP/EO share usually less than 2% of the Service's total. As the number, size, and complexity of employee plans and exempt organizations grew dramatically, EP/EO actually saw its staff and budget shrink. The staffing and authorization levels for EP/EO in recent years are shown in Exhibit I on page 198. Less than 40% of the EP/EO budget, or approximately \$50 million annually, is dedicated to the Exempt Organizations Division.<sup>14</sup>

As a result of these budgetary pressures, EP/EO has not in-

creased its staff, even though its responsibilities have more than doubled. It actually had slightly fewer employees in fiscal 1998 (2,045) than it did in fiscal 1975 (2,075).<sup>15</sup>

This paucity of staff reflects the overall staffing pressures at the IRS. In June 1995, anticipating possible reductions from the amount the Administration had requested for fiscal 1996, the IRS began to take steps to reduce its staffing levels. On 6/30/95, the IRS announced a hiring freeze. Earlier in the year, it had announced an "early-out" program without incentives for employees affected by its district office and regional office consolidations. After enactment of its final appropriation, the IRS reopened the early-out program through 2/3/96 and made it available to all employees. About 1,690 staff retired as a result of this program.<sup>16</sup> As a result, by early 1997 the overall IRS staffing level for EP/EO was approximately 20% below the 1989 peak staffing level of 2,573 positions.<sup>17</sup>

Of the 2,045 full-time EP/EO employees during 1998, approximately 250 positions were assigned to National Office headquarters and the remainder to the five KDOs. The Exempt Organization Division's share of these is 900 positions, with ap-

proximately 110 National Office staff and 790 field staff, although not all of these positions are currently filled. The field staff, who report primarily to the district directors of the KDOs, are divided into 400 examination staff, 170 determination staff, and 220 support staff.<sup>18</sup>

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In addition to a reduction in overall positions, current EP/EO staffing also reflects a critical loss of some of EP/EO's most talented personnel, resulting in a "brain drain." At the executive level, the 1974 ERISA legislation establishing EP/EO authorized the creation of a number of high-level executive positions for the new office, authorizing 20 "supergrade" positions. This unprecedented concentration of high-level positions attracted a pool of talented people both from within and outside the IRS to staff the new EP/EO. Since 1974, however, as a result of various internal organizations and redefinitions of staffing priorities, all but four of these EP/EO "supergrade"

<sup>9</sup> *Id.*; General Accounting Office, Tax Administration, *IRS Fiscal Year 1996 and 1997 Budget Issues and the 1996 Filing Season*, 104th Cong., 2d Sess. 1 (3/28/96) (testimony before the House Ways and Means Oversight Subcommittee, hereinafter "GAO 1997 IRS Budget Testimony").

<sup>10</sup> Godfrey, "Congress Approves \$7.2 Billion IRS Budget," 73 Tax Notes 8 (10/7/96); Godfrey, "House Approves Deep Cuts to IRS Budget," 72 Tax Notes 383 (7/22/96); GAO 1997 IRS Budget Testimony 1.

<sup>11</sup> Rieschick, "Clinton Signs 1998 Treasury Postal Appropriations Bill, 77 Tax

Notes 269 (10/20/97); General Accounting Office, Tax Administration, *IRS' Fiscal Year 1998 Budget Request*, 105th Cong., 1st Sess. 16 (6/13/97) (testimony before the Senate Appropriations Treasury and General Government Subcommittee, hereinafter "GAO 1998 IRS Budget Testimony").

<sup>12</sup> GAO 1999 IRS Budget Testimony at 26.

<sup>13</sup> Glenn, "'Monster' Budget Bill Signed," 81 Tax Notes 399 (10/26/98).

<sup>14</sup> See Reforms to Improve the Tax Rules Governing Public Charities, Hearings Before the Subcommittee on Oversight of the House Committee on Ways and Means,

H.R. Rep. No. 122, 103d Cong., 2d Sess. 4 (1994) (hereinafter "Pickle Report").

<sup>15</sup> Speech by James J. McGovern before the National Commission on Restructuring the IRS, reprinted in 16 Exempt Org. Tax Rev. 209 (Feb. 1997) (hereinafter "McGovern Speech").

<sup>16</sup> See GAO 1997 IRS Budget Testimony at 4.

<sup>17</sup> See 1998 Joint Committee Report at 13.

<sup>18</sup> See Booz-Allen & Hamilton, "Preliminary Report on Status of IRS Reorganization" (June 1998), excerpts reprinted in BNA Daily Tax Report, 7/1/98, page L-1 (hereinafter "BAH June 1998 Report").

to be made in the case of assets used for both exempt and taxable purposes. In other areas there are dozens, sometimes hundreds, of private rulings involving an issue as to which the Service and Treasury have issued no precedential advice, such as hospital organizations and joint ventures.<sup>24</sup>

Stating that "there apparently is some obstacle" to the issuance of the preferred forms of guidance—regulations and revenue rulings—the White Paper went so far as to suggest that, as an alternative, Congress could mandate precedential effect for "private letter rulings, technical advice memoranda, general counsel memoranda, and other internal documents."<sup>25</sup>

Another example of the impact of inadequate staffing of the exempt organization guidance function was the decision of the IRS in 1997 to forgo publishing the fiscal 1998 Exempt Organizations Continuing Professional Education Technical Instruction Program (CPE) text. Marcus Owens, Director of the IRS Exempt Organizations Division, attributed this decision to the fact that the IRS Exempt Organizations Division simply had too few people doing too much work, and that revising the Internal Revenue Manual took priority over the CPE text. He was therefore forced to provide better information to agents conducting examinations at the cost of providing less information to the public.<sup>26</sup>

Compliance efforts have also suffered from the lack of adequate funding and staff levels. The two primary programs through which the IRS seeks to ensure compliance with the requirements for tax exemption of nonprofit organizations and employee plans are the exemption determination letter program and the annual return requirement, complemented by the

examination process. The sheer magnitude of these programs is staggering. In 1996, the IRS received approximately 70,000 exemption applications from nonprofit organizations and issued approximately the same number of determination letters, up from approximately 60,000 three years earlier. At the same time, the number of technical specialist positions assigned to processing determination letters has been reduced from approximately 200 in 1996 to 170 in 1998, and many of the 170 positions remain unfilled.<sup>27</sup>

A look at examination coverage reveals similar problems. In fiscal 1996, 563,710 annual information returns (usually Form 990 or Form 990-EZ) were filed by tax-exempt organizations, up from 527,847 just three years earlier.<sup>28</sup> At the same time, only 11,000 exempt organization returns were examined, and less than 50% of those returns were annual information returns. The rest were employment tax returns or unrelated business income tax returns that were presumably audited in connection with an organization's annual information return.<sup>29</sup> In other words, it is likely that less than 5,500 organizations were actually audited, compared with 7,541 organizations as recently as 1989.<sup>30</sup>

This figure represents an incredibly small percentage of all exempt organizations. In 1996, there were over a million tax-exempt organizations (excluding churches that are not required to file annual returns and are subject to the higher audit threshold imposed by Section 7611). More than half of these filed annual returns. Thus, only about 0.5% of tax-exempt organizations and only about 1.0% of annual returns were audited in 1996. By comparison, in 1996 the IRS audited 1.67% of individual returns, 2.34% of corporate re-

turns, and 49.61% of the returns of large corporations (those with \$250 million or more in annual revenues).<sup>31</sup>

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one—that has repeatedly asked for greater IRS scrutiny and regulation.<sup>32</sup> It is therefore ironic that both the guidance and compliance functions of the IRS in this area have been hindered so significantly by a lack of adequate funding and staffing. While the vast majority of exempt organizations undoubtedly comply with the relevant tax provisions, the reduction in guidance and compliance activities can only result in more exempt organizations violating these

<sup>24</sup> 1994 ABA White Paper at 77.

<sup>25</sup> *Id.*; see also McGovern and Brand, *supra* note 22.

<sup>26</sup> Wright & Stokeld, "EO Practitioners Disappointed IRS Won't Publish Fiscal '98 CPE Text," 74 Tax Notes 1379 (3/17/97).

<sup>27</sup> See 1998 Joint Committee Report at 9; Pickle Report at 3-4; BAH June 1998 Report at page L-14; "IRS Official Upbeat on Centralizing Exemption Application Processing," 10 EOTR Weekly 62 (6/1/98).

<sup>28</sup> See 1996 IRS Data Book at 14; Pickle Report at 3. Employee plans filed 1,185,864 returns in 1996. 1996 Data Book at 14.

<sup>29</sup> See 1996 IRS Data Book at 14, 33.

<sup>30</sup> See Pickle Report at 4.

<sup>31</sup> 1996 IRS Data book at 12, 14.

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provisions, whether inadvertently or intentionally, and in those violations continuing for longer periods of time before they are discovered and dealt with. This situation can only lead to an erosion of public confidence in exempt organizations.

### THE NEW TAX-EXEMPT OPERATING DIVISION

Responding to criticisms of the IRS, Congress formally began the current restructuring process in 1995 by creating the National Commission on Restructuring the Internal

Revenue Service.<sup>33</sup> The Commission consisted of politicians, business people, tax advocates, practitioners, union representatives, and Treasury representatives appointed by the congressional leadership and the President. It began its work in July 1996, holding meetings and public hearings throughout the rest of the year and into 1997.<sup>34</sup> In January 1997, when Margaret Milner Richardson announced her intention to resign as IRS Commissioner, at least one member of Congress publicly called for President Clinton to appoint a non-tax professional as the next Commissioner.<sup>35</sup>

The Commission recommended that Congress provide sufficient resources when asking IRS to assume functions such as those carried out by EP/EO, noting that the resources committed to such operations must be in addition to, and not in lieu of, resources appropriated to carry out revenue collecting. Specifically, the Commission's recommended continuation of the mandatory funding mechanism in Section 7802(b)(2), modified to earmark the funds for the exclusive use of EP/EO so this mechanism would no longer be an empty promise.

At the same time, President Clinton responded to the calls for someone other than a tax profes-

sional to head the IRS by nominating Charles O. Rossotti, an executive at an information technology management firm. Wasting no time in seeking to address the concerns of IRS critics, he proposed in January 1998 a sweeping reorganization of the IRS to give better service to its "customers," the taxpayers. His core proposal was to change the nature of the Service's organization from geographical (i.e., district, regional, and national offices) to functional, based on four primary operating divisions oriented toward the types of taxpayers they primarily served: individuals subject to wage withholding, small businesses and the self-employed, medium and large corporations, and tax-exempt entities.<sup>38</sup>

To implement this reorganization, Commissioner Rossotti hired the consulting firm of Booz-Allen & Hamilton (BAH) in February 1998. BAH and Congress subsequently approved the four operating divisions proposal, including the designation of one of the divisions to provide services to "tax-exempt" entities, a category that includes employee plans and state and local governments as well as exempt organizations.<sup>39</sup>

Congressional approval came in the form of the IRS Restructuring and Reform Act of 1998 ("Restructuring Act"). Besides affirming the overall structure proposed

novative and efficient functions within the IRS," even though its function is "non-core" or not related to revenue collecting.<sup>37</sup> This characterization is, of course, misleading, because the function of EP/EO is to ensure that organizations claiming tax exemption are indeed qualified to receive it, in the same way that it is the function of other parts of the IRS to ensure that individuals and organizations claiming tax deductions or credits are in fact entitled to such deductions or credits. The regulation of the EP/EO sector therefore is just as important and just as "core" as any of the "revenue collecting" functions of the IRS.

In June 1997, the Commission issued its report: "A Vision for a New IRS." The major recommendation of the report was that the primary goal of the IRS should be "taxpayer satisfaction."<sup>36</sup> The report specifically addressed the creation of EP/EO in 1974 and complimented its subsequent operations as "one of the most in-

<sup>33</sup> See P.L. 104-52, section 637, 109 Stat. 468 (11/19/95).

<sup>34</sup> See "Clinton To Appoint Five to IRS Restructuring Commission," 71 Tax Notes 1454 (6/10/96); "Congress Names Its Members to the IRS Restructuring Commission," 71 Tax Notes 1165 (5/27/96).

<sup>35</sup> See Donmoyer, "Next Commissioner Should Be Outsider, Grassley Says," 74 Tax Notes 993 (2/24/97); Stratton and Godfrey, "IRS Commissioner Richardson Resigns," 74 Tax Notes 134 (1/13/97).

<sup>36</sup> National Commission on Restruc-

turing the Internal Revenue Service, "A Vision for a New IRS," reprinted in 75 Tax Notes 1681 (6/30/97).

<sup>37</sup> *Id.* at 1702.

<sup>38</sup> Donmoyer and Guttman, "IRS Announces Major Overhaul as Finance Committee Holds Hearings," 78 Tax Notes 495 (2/2/98).

<sup>39</sup> See BAH June 1998 Report at L-1; Restructuring Act section 1001(a); S. Rep't No. 105-174, 105th Cong., 2d Sess. 8-9 (1998); 1998 Blue Book 17-18.

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by Commissioner Rossotti, the Restructuring Act (1) created a nine-member IRS Oversight Board and (2) changed the reporting responsibility of the IRS Chief Counsel.<sup>40</sup>

To facilitate the reorganization of the IRS, the Restructuring Act also eliminated Section 7802(b)(1), which had created the separate EP/EO office within the IRS.<sup>41</sup> The legislative history emphasized, however, that Congress intended that a comparable structure be created administratively to ensure that adequate resources are devoted to the functions now handled by EP/EO.<sup>42</sup> Finally, the Act emphasized above all else the need for the IRS to put a greater emphasis on serving the public and meeting the needs of all taxpayers.

As part of the restructuring legislation, Congress also considered the Commission's recommendation that the Section 7802(b)(2) dedicated funding provision be maintained and strengthened. The 1998 Joint Committee on Taxation report analyzing the House and Senate versions of the restructuring legislation supported elimination of the Section 7802(b)(2) funding mechanism on two basic grounds:

1. Collections from the Section 4940 excise tax are based on investment income and thus are very much subject to the vicissitudes of the financial markets. The Joint Committee reached basically the same conclusion with respect to a proposal to dedicate user fees gathered from exempt organizations and employee plans, noting that user fees are also an inherently unstable source of revenue. The report also pointed out that if it is appropriate to dedicate these user fees to the Service's ex-

empt organization and employee plan functions, it might be appropriate for other areas of the IRS to retain the user fees collected from taxpayers under their jurisdiction.<sup>43</sup>

2. Earmarking Section 4940 excise taxes, user fees, or both, would not necessarily produce the needed financial resources, and could result in the misallocation of resources within the IRS. Although the Joint Committee agreed that the current level of EP/EO funding was too low, its report calculated that the formula set out in the Senate bill would have resulted in approximately \$465.6 million for EP/EO in 1997, an amount approximately 3 1/2 times the level of proposed funding (\$129.6 million) for that year.<sup>44</sup>

The 1998 Joint Committee Report ultimately concluded that the task of determining correct levels of funding for EP/EO requires an ongoing assessment by Congress of the appropriate funding level rather than a formula that may or may not approximate the current or future needs. The Joint

Committee view prevailed and the restructuring legislation was enacted without a statutory funding mechanism.

**The new structure.** Despite the elimination of the statutory EP/EO Office, the transformation of the tax-exempt function into one of

**The Restructuring Act eliminated the EP/EO office.**

only four operating divisions has the potential to significantly elevate the profile of its function for both funding and staff purposes.

The plan for the new Tax-Exempt Operating Division was fleshed out in three reports issued by BAH on 10/1/98.<sup>45</sup> The first of these reports includes BAH's recommendations for the basic organizational structure that includes four operating divisions and various core or shared services at the National Office level.<sup>46</sup> The second report sets out the firm's recommendations for the Counsel and other specialized functions.<sup>47</sup> The third provides a timeline for the remaining two phases of the restructuring.<sup>48</sup> The "very prelimi-

<sup>40</sup> Restructuring Act, sections 1101(a) and 1102(a), amending Sections 7802 and 7803. The reporting responsibilities of the Chief Counsel are discussed below.

<sup>41</sup> IRS Restructuring Act section 1101(a). While Congress abolished the EP/EO office, the new IRS structure uses the EP/EO model of organizing IRS operations based on the type of taxpayer instead of geography.

<sup>42</sup> See S. Rep't No. 105-174, 105th Cong., 2d Sess. 20 (1998); 1998 Blue Book 30.

<sup>43</sup> 1998 Joint Committee Report 66-67. See also 1998 Blue Book 30.

<sup>44</sup> 1998 Joint Committee Report at 69.

<sup>45</sup> The BAH "reports" are actually reproductions of overhead projections that

are available through Tax Analysts (Doc 98-30779).

<sup>46</sup> Booz-Allen & Hamilton, "Organization Architecture, Operating Divisions, Shared Services," 10/1/98 (hereinafter "BAH Operating Divisions Report").

<sup>47</sup> Booz-Allen & Hamilton, "Organization Architecture, Information Systems Specialty Taxes, Shared Services," 10/1/98 (hereinafter "BAH Specialty Functions Report"). The BAH October reports did not include recommendations for either the Appeals or the Criminal Investigation functions.

<sup>48</sup> Booz-Allen & Hamilton, "Organization Architecture, Moving Forward," 10/1/98 (hereinafter "BAH Moving Forward Report").

nary" timeline in the third report shows that all of the Service's new operating divisions and the new National Office structure are scheduled to be fully implemented by 2001, with the Tax-Exempt Operating Division fully operational by the end of 2000.

The structure proposed by BAH for the Tax-Exempt Operating Division includes three subdivisions based on the types of orga-

ness organizations to be served: exempt organizations, employee plans, and governmental entities.<sup>49</sup> Each subdivision would in turn be divided into functional areas. Recent public comments by Assistant Commissioner (EP/EO) Evelyn Petschek, head of the Tax-Exempt Operating Division design team, indicates that there will be four functional areas under each subdivision: education and communication, rulings and agreements, customer account services, and compliance.<sup>50</sup> The final structure, however, is still subject to change.

The restructuring legislation was enacted without a statutory funding mechanism.

While there have been some transitional problems, these efforts should eventually provide for more efficient and effective handling of these functions.<sup>52</sup>

Another ramification of this new structure is that the Tax-Exempt Operating Division would have greater control over field personnel than was enjoyed by the EP/EO National Office. As noted in the 1994 ABA White Paper:

We believe that the administration of the tax laws applicable to exempt organizations must be consistent and even handed. In our view this requires a strong National Office

in the exempt organizations area to set priorities, to create uniform interpretations of the law, and to oversee field personnel working in the area. We see significant disparities among Key Districts in their interpretations and enforcement of the law, significant differences in the time for processing determinations, and insufficient direct accountability by field personnel to the National Office, making it difficult for the National Office to bring about the desired consistent and even handed administration and achievement of national objectives.<sup>53</sup>

This concern has been addressed in the new structure by replacing the geographically based reporting lines with functional reporting lines, thereby giving the Tax-Exempt Operating Division primary oversight over all IRS staff assigned to work with such organizations, including field staff.<sup>54</sup>

In sum, the new basic structure appears to be a significant gain for tax-exempt organizations. The increased prominence of the office, the continued centralization of application and return processing, the line authority over agents in the field, and the increased emphasis

<sup>49</sup> BAH Operating Divisions Report, section VI.

<sup>50</sup> Stokeld, "Petschek Discusses Effects of IRS Restructuring on EOs," 51 Highlights & Documents 1824 (11/23/98); Yull, "Official Urges Attorneys to Send Comments Soon on IRS Redesign of Exempt Function," BNA Daily Tax Report, 11/16/98, page G-1.

<sup>51</sup> See Stokeld, *supra* note 51; BAH Operating Divisions Report, section VI.

<sup>52</sup> The transition problems have included positions in Cincinnati that have yet to be filled. Because of this staff shortfall, many exemption applications have had to be "farmed out" to other key district offices, resulting in delays and inexperienced staff reviewing some applications.

See "IRS Official Upbeat on Centralizing Exemption Application Processing," 10 EOTR Weekly 62 (6/1/98). Budget cuts have also had an effect, particularly on the processing of returns at the Ogden, Utah, Service Center. See McGovern Speech at 212 (describing how a plan to key into a database all of the financial data on Form 990 fell victim to the overall IRS budget cuts).

<sup>53</sup> 1994 ABA White Paper at 79.

<sup>54</sup> While the EP/EO field staff will be reporting primarily to the Tax-Exempt Operating Division and not to local district directors, the field staff probably will still be distributed geographically in a manner similar to the current key district structure. Stokeld, *supra* note 51.



on education of the public should all help to resolve the problems that have dogged exempt organization oversight, including the lack of adequate funding and staff, the lack of consistency in the field, and the lack of sufficient published guidance and educational materials. There are, however, several significant issues that are still to be resolved.

## REMAINING ISSUES

In September 1998, Phase II of the restructuring process began when twelve design teams began the five-month process of developing the details of the new IRS structure. The teams are centered around the four new operating divisions and eight areas of the IRS that are not part of any of the operating divisions, including Appeals, the Chief Counsel, and the Taxpayer Advocate. In addition to the design team for the Tax-Exempt Operating Division, a five-person team responsible for the exempt organization function (headed, like the main team, by Assistant Commissioner Petschek), began actively seeking comments from practitioners and from "customers"—the exempt organizations themselves. The process is on a fast track because plans from all of the design teams are due by 2/15/99.

Once all of the individual plans have been completed, they will be integrated into an overall restructuring "blueprint" that is scheduled to be completed by 4/15/99. While the plans for all the operating divisions of the IRS are to be completed at the same time, IRS officials have stated that the first plan to be implemented will be that for the Tax-Exempt Operating Division, because the small size and current management structure of this unit makes quick implementation possible.<sup>55</sup>

Several issues remain to be decided, including:

1. The role of the Chief Counsel in the new EP/EO function.
2. The allocation of certain responsibilities both within the Tax-Exempt Operating Division and between it and the other three operating divisions.
3. Whether to establish voluntary compliance programs for the charitable community similar to those available to the employee plans community.
4. Whether to create an Exempt Organizations Counsel position within Treasury.
5. The final location of the EP/EO National Office functions.

**The Chief Counsel.** The relationship between the IRS Chief Counsel and the Tax-Exempt Operating Division is one of the most important remaining issues. Correctly structuring this relationship is critical to reversing the dramatic decline in precedential guidance while maintaining high standards for all guidance. Actually, there are two interrelated issues that have yet to be decided regarding this relationship:

- The allocation of primary responsibility for precedential

and non-precedential guidance.

- What, if any, reporting relationship will exist between the new Tax-Exempt "Division Counsel" and the head of the Operating Division.

The Exempt Organization Division has been responsible for non-precedential guidance such as exemption determination letters,

**The Tax-Exempt Operating Division includes three subdivisions based on the types of organizations to be served.**

private letter rulings, and TAMs since the creation of EP/EO in 1974.<sup>56</sup> The Division's technical staff, however, regularly consults with the Chief Counsel's staff when legal issues arise during drafting. For precedential guidance such as revenue procedures and revenue rulings, the Division has primary drafting responsibility, with the Chief Counsel's office and Treasury exercising review and approval authority.<sup>57</sup> For regulations, the Chief Counsel's office is the primary drafter with the draft regulations subject to formal review and approval by the Exempt Organization Division and Treasury.<sup>58</sup>

Neither BAH nor the Internal

areas of the Code, precedential and non-precedential rulings have been handled primarily by the Chief Counsel's office for at least the last ten years.

<sup>58</sup> The Chief Counsel's office is also primarily responsible for Tax Court litigation (the Department of Justice is responsible for tax litigation in other courts). For tax legislation affecting exempt organizations, Treasury is the primary drafter, although both the Exempt Organization Division and the Chief Counsel are consulted.

<sup>55</sup> Congel, "EP/EO Slated as First Division to be Restructured Next Year," BNA Daily Tax Report, 9/21/98, page G-1; BAH Moving Forward Report at "Overall Timeline."

<sup>56</sup> In general, the exempt organization technical staff in the National Office issues letter rulings and TAMs, while the key district offices issue exemption determination letters.

<sup>57</sup> The Exempt Organization Division is unique in this regard. For all of the other

Revenue Service Advisory Counsel (IRSAC) committee that reviewed the BAH report on the Chief Counsel explicitly addressed the issue of where responsibilities should lie for the issuing guidance for exempt organizations. IRSAC did, however, acknowledge that certain operating divisions might require centralized technical ex-

- A geographic segment consisting of local litigation staff.
- Four "Operating Division Counsel" corresponding to the four operating divisions of the IRS.<sup>62</sup>

Each Division Counsel office will provide general legal services, technical knowledge, and procedural advice to its corresponding operating division, with an estimated 20 to 40 attorneys assigned to each office.<sup>63</sup>

There was disagreement between BAH and IRSAC over the reporting structure that should exist between the head of each Operating Division and the respective Division Counsel office. Only one member of the IRSAC committee reviewing the BAH report agreed with BAH that the Division Counsel should report primarily to the Chief Counsel. A majority of the committee recommended instead that the Division Counsel should report primarily to the head of the respective Operating Division and only secondarily to the Chief Counsel.<sup>64</sup>

The core principle underlying the overall IRS restructuring effort is improving customer satisfaction through vertical integration of services to provide for clear lines

of authority and accountability. In the authors' view, this argues strongly for concentrating IRS exempt organizations technical staff in a single office (rather than separating this staff, as at present, between the Exempt Organizations Technical Division and the EP/EO group in the Chief Counsel's office) with primary drafting responsibility for *all* exempt organizations guidance. This conclusion follows from a basic principle of organizational management—divided responsibility and lack of clear lines of accountability virtually guarantee an inefficient process. Anyone who has ever tried to coordinate a complex project across organizational boundaries knows all too well the added complexity and inefficiency involved. The greatly diminished productivity of the Service's exempt organization guidance function in recent years appears due, at least in substantial measure, to such coordination problems between the Exempt Organizations Division and the Chief Counsel. Given the overriding importance of reviving the guidance process, eliminating this inefficiency by concentrating technical resources and guidance responsibility within a single organizational unit should be a

**The Tax-Exempt Operating Division would have greater control over field personnel than was enjoyed by EP/EO.**

pertise in those operating divisions that would be responsible for issuing non-precedential guidance. Other divisions, by comparison, might benefit from a more decentralized approach, with the technical staff responsible for issuing non-precedential guidance being located in the Division Counsel office.<sup>59</sup>

With respect to the reporting structure, the Restructuring Act requires that the Chief Counsel report directly to both the Commissioner and Treasury with respect to (1) legal advice or interpretation of tax law not relating solely to tax policy, and (2) tax litigation. The Chief Counsel is to report to Treasury alone with respect to tax policy matters such as proposed legislation and international tax treaties.<sup>60</sup> The Restructuring Act further provides that "[a]ll personnel in the Office of Chief Counsel shall report to the Chief Counsel."<sup>61</sup>

As envisioned by BAH, the Chief Counsel's office in the restructured IRS will be divided into three elements:

- A centralized technical function including legal experts in specific areas of the tax laws.

<sup>59</sup> *Internal Revenue Service Advisory Council Agenda and Minutes*, section 4, 10/6/98 (hereinafter "IRSAC Report"), available from Tax Analysts as 98 TNT 195-62.

<sup>60</sup> Section 7803(b)(3). Before passage of the Restructuring Act, the Chief Counsel reported only to the General Counsel (Treasury). The legislative history of the Restructuring Act indicates that the areas of the Chief Counsel's dual reporting will encompass legal advice or interpretation of the tax laws set out in regulations, revenue rulings, revenue procedures, technical advice and other similar memoranda, private letter rulings, and other published guidance. 1998 Blue Book 28.

<sup>61</sup> See also 1998 Blue Book 28, which clarified this phrase by adding "(and not to any person at the IRS or elsewhere within the Treasury Department)".

<sup>62</sup> BAH Specialty Functions Report section II.

<sup>63</sup> See IRSAC Report § 4.

<sup>64</sup> IRSAC Report § 4; Hamilton, "IRS Councils' Reporting Structure Needs Advisory Counsel," 51 *Highlights & Documents* 179 (10/7/98). Neither side appeared to see a significant impediment to its recommendations in the requirement of Section 7803(b)(4) that Chief Counsel staff report to the Chief Counsel, although the IRSAC report mentioned it in passing. See IRSAC Report § 4.

central feature of the new organizational structure.

This, in turn, raises the question of whether these staff resources and guidance responsibilities should be concentrated in the Operating Division or in the Division Counsel's office. This is a close question. Considerations of timeliness, responsiveness to the practical realities facing exempt organizations, and administrative efficiency may argue in favor of locating the technical resources within the Operating Division. By virtue both of its continuing educational outreach activities and its audit program, the Operating Division may be in a better position than the Division Counsel to stay in touch with emerging developments in the exempt organizations field. It may also be in a better position to gauge the practicality of alternative legal positions in relation to the actual operations of exempt organizations. Likewise, the Operating Division may also be in a better position to assess the impact of alternative legal positions on the Service's ability to efficiently administer the exempt organization rules.

On the other hand, locating exempt organizations' technical resources in the Division Chief Counsel's office—with primary accountability to the Chief Counsel—is seen by many as an essential safeguard against legal analysis that is excessively driven by results. This safeguard would not be present if the exempt organizations technical staff was part of the Tax-Exempt Operating Division.

The optimum balance between these two countervailing considerations may be to place the technical staff (and primary guidance responsibility) in the Division Counsel's office. At the same time, the head of the Operating Division should get a strong enough role in hiring and evaluating the

Division Counsel to ensure that the Division Counsel staff would be fully responsive to the needs and priorities of the Operating Division.

**Allocation of responsibilities.** The IRS restructuring has also provided an opportunity to examine the allocation of responsibility between the Exempt Organizations Division and other parts of the IRS. Two much-discussed issues in this allocation are:

- Whether tax-exempt hospitals should be under the jurisdiction of the Tax-Exempt Operating Division or grouped with non-exempt hospitals under the jurisdiction of the Middle Market/Large Corporate Operating Division.<sup>65</sup>
- Whether public institutions, such as public universities, should be under the jurisdiction of the exempt organization subdivision or the government entities subdivision of the Tax-Exempt Operating Division.<sup>66</sup>

The Exempt Organizations Division currently has jurisdiction over all tax-exempt organizations; even those, such as hospitals, that have significant numbers of non-exempt counterparts. The Exempt Organizations Division also has jurisdiction over public institutions (1) if they formally apply for exempt status or (2) to the degree that they become involved in the issuance of tax-exempt bonds and unrelated business income issues.

The experience of the Exempt Organization Coordinated Examination Program indicates that tax-exempt hospitals raise significantly more exempt organizations issues than general corporate income tax issues, including private inurement, private

benefit, and intermediate sanctions issues. Shifting exempt hospitals out of the Tax-Exempt Operating Division would result in these issues being addressed by an examination and technical staff with little or no exempt organizations

**The new basic structure appears to be a significant gain for tax-exempt organizations.**

experience. Such divided responsibility for these critical exempt organizations issues has obvious potential for both inconsistent and inefficient results, and seems squarely at odds with the Commissioner's fundamental goals for the restructuring.<sup>67</sup> These considerations strongly suggest that jurisdiction over tax-exempt hospitals should remain with the Tax-Exempt Operating Division.

The decision of whether jurisdiction over public institutions should go to the exempt organizations subdivision or the government entities subdivision seems much less critical. Effective coordination between the two subdivisions will be essential in either event since public institutions raise important issues within the primary jurisdiction of both subdivisions. The Operating Division staff will need to be attentive to the need to ensure consistent and accurate application of the exempt organizations tax rules.

<sup>65</sup> See Stokeld, *supra* note 51.

<sup>66</sup> Stokeld, IRS Reorganization Will Change Handling of EO Issues, *Owens Predicts*, 22 Exempt Org. Tax Rev. 249 (Nov. 1998).

<sup>67</sup> This view is shared by Assistant Commissioner Petschek, who has stated that she believes "quite strongly that exempt hospitals are exempt organizations first and hospitals second." Stokeld, *supra* note 51 at 1825.

### **Voluntary compliance programs.**

Stimulated in part by enactment of the intermediate sanctions legislation, various commentators have suggested that the Tax-Exempt Operating Division should administer formal voluntary compliance programs similar to those already administered for employee plans. At present, the

**The Chief Counsel's office would have a Division Counsel for each operating division.**

only effort in this direction by the present Exempt Organizations Division is the development of a Voluntary Compliance Nonresident Alien Withholding Program.<sup>68</sup> By contrast, the Employee Plans Division currently administers a number of voluntary compliance programs, such as the Walk-In Closing Agreement Program and the Voluntary Compliance Resolution Program, to promote voluntary compliance and self-correction on the part of employee plans.

The issue came before a recent meeting with the employee plans members of the Tax-Exempt Operating Division design team. There, representatives of many of the large employee plan vendors and sponsors strongly endorsed retention of the existing employee plan voluntary compliance programs, although they remarked on the need for greater uniformity and efficiency in the administration of these programs. Given the generally favorable experience with the employee plan programs, development of similar exempt organization voluntary compliance programs seems worth careful exploration.

**Exempt Organizations Counsel in Treasury.** While insufficient staff

and funding within the IRS have clearly been major causes of the recent lack of guidance for exempt organizations, insufficient staffing at Treasury at various times in recent years also has been a significant contributing factor. This has prompted some observers to recommend that Treasury establish an Exempt Organizations Counsel, similar to the existing Benefits Tax Counsel, to institutionalize a priority commitment to exempt organizations issues.<sup>69</sup>

Currently, jurisdiction in Treasury over exempt organizations and most other tax issues rests with the Tax Legislative Counsel's office, usually with one or two attorney-advisors focusing primarily on exempt organization issues. Congress, however, has directed Treasury to create separate International Tax Counsel and Benefits Tax Counsel offices to provide dedicated staff to address international tax and employee benefits issues.

The specialized and largely self-contained nature of exempt organizations rules, and the urgent need to ensure an effective guidance program for exempt organizations, argues strongly for creation of a single Treasury office for exempt organizations. Otherwise, staffing for exempt organizations matters within the Tax Legislative Counsel's office is likely to ebb and flow over time depending on the press of other issues and the current Tax Legislative Counsel's degree of interest in those matters.

**Office location.** The BAH preliminary organization concept incorporates the Commissioner's proposal for four operating divisions and a headquarters or core operation with a much smaller headquarters staff. BAH anticipates that the number of activities that will be part of the

IRS core headquarters will be quite small and primarily strategic in nature, with a number of the activities and responsibilities that are currently part of the National Office becoming part of the appropriate operating divisions.<sup>70</sup>

At present, the Exempt Organization Division technical staff is located in the National Office of the IRS in Washington, D.C., with determination specialists and examiners divided among the key district offices. Relocating one or more of the other three operating divisions outside of Washington may make good business sense. For example, it has been suggested that the Wage and Investment Division should be located in close proximity to one of the Service's major return-processing centers. No such compelling rationale has emerged for relocating the Exempt Organizations Division, however. On the other hand, the present Washington location offers obvious benefits, including easier interaction with Treasury, the IRS headquarters functions, and Congress. Presumably reflecting these considerations, various IRS officials involved in the restructuring process have indicated that the Exempt Organizations Division is likely to remain in the Washington area. Because political and public relations considerations may argue for a location outside

<sup>68</sup> 1998 Joint Committee Report at 9.

<sup>69</sup> McGovern Speech at 211; ABA White Paper at 79.

<sup>70</sup> The remaining core or headquarters activities would include enterprise-wide shared services such as support services, printing and distributing forms, legislative affairs and communications, strategy and development, financial management, human resources, and some specialized missions such as collecting statistics and federal and state relations. BAH Operating Divisions Report at I-9.



of the District, there is speculation that the Exempt Organizations Division will be moved to the IRS facility in suburban New Carrollton, Maryland.

## **FUNDING**

Restructuring the Service's exempt organizations function along the lines outlined above is a necessary condition for ensuring effective IRS oversight of exempt organizations. It is not, however, enough. The other critical element is increased funding.

As discussed in detail above, the lack of adequate funding and staffing has undermined all of the core functions of the current Exempt Organizations Division. Currently, review of exemption applications is necessarily limited. Publication of guidance has, until recently, been almost non-existent. Audit coverage is minimal and the Exempt Organizations Division has been forced to curtail important education and outreach activities. The key point that needs to be squarely recognized by the Commissioner, Congress, and Treasury is that the critical problems in the exempt organization area cannot be addressed by reallocating resources within the exempt organization function because all key aspects of the function are substantially underfunded. Only a significant infusion of new money can restore and sus-

tain the effective IRS oversight of exempt organizations.

This can clearly be accomplished without undue strain on the overall IRS budget. For example, the current budget for the Exempt Organizations Division (National Office and field staff) is roughly \$50 million per year out of a total IRS annual budget of approximately \$8 billion. Thus, increasing the exempt organization budget by 20% would require only \$10 million—one-eighth of one percent of the total IRS budget.

One critical resource issue deserves special mention—making the investment in technology required to move quickly to electronic filing of exempt organizations' returns. Currently, most annual information return information is not even entered into the IRS computer system. By encouraging electronic filing of exempt organizations' annual information returns—i.e., Forms 990, 990-EZ, and 990-PF—the IRS will substantially improve the collection, verification, and publication of statistical information about the nonprofit sector. Making these data available electronically will strengthen IRS compliance efforts, improve the ability of state and local authorities to regulate exempt organizations, and, perhaps most importantly, greatly facilitate public and media oversight of exempt organizations.

## **CONCLUSION**

The restructuring of the IRS presents a once-in-a-generation opportunity to strengthen the Service's oversight of exempt organizations. The process to date offers considerable grounds for optimism. The creation of the Tax-Exempt Operating Division as one of four new operating divisions would seem to virtually guarantee greater prominence for exempt organizations issues. Further, the emphasis on customer service and outreach augers well for an increased emphasis on the guidance process—clearly the most pressing need in the exempt organizations area.

Creating a truly effective working relationship between the Tax-Exempt Operating Division and the Tax-Exempt Division Counsel is the most important "design" issue yet to be resolved and here, too, the preliminary direction is encouraging. Whether the considerable promise of the new structure is realized in practice, however, turns largely on whether the exempt organization function receives a significant and sustained increase in funding. Given the exempt organization community's long-term interest in effective IRS oversight, it behooves exempt organization leaders to do everything within their power to ensure this result. ■