

**CHARITIES AND EMPLOYMENT TAXES: ARE
CHARITIES IN THE COMBINED FEDERAL CAMPAIGN
MEETING THEIR EMPLOYMENT TAX
RESPONSIBILITIES?**

HEARING
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
OF THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

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**CHARITIES AND EMPLOYMENT TAXES:
ARE CHARITIES IN THE COMBINED FEDERAL
CAMPAIGN MEETING THEIR EMPLOYMENT
TAX RESPONSIBILITIES?**

THURSDAY, MAY 25, 2006

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The Subcommittee met, pursuant to notice, at 11:02 a.m., in room 1100, Longworth House Office Building, Hon. Jim Ramstad (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE
May 18, 2006
OV-7

CONTACT: (202) 225-7601

Ramstad Announces Hearing on Charities and Employment Taxes: Are Charities in the Combined Federal Campaign Meeting Their Employment Tax Responsibilities?

Congressman Jim Ramstad (R-MN), Chairman, Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on charities and employment tax compliance. **The hearing will take place on Thursday, May 25, 2006, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 11:00 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. Witnesses will include the Internal Revenue Service (IRS), U.S. Government Accountability Office (GAO), and the Office of Personnel Management (OPM). However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

Under the law, employers who compensate their employees are required to withhold certain taxes from an employee's paycheck, known as employment or payroll taxes. Employment taxes include Federal income tax withholding, Social Security, Medicare and Federal Unemployment Tax. Entities organized under section 501(c)(3) of the Internal Revenue Code must pay all employment taxes except Federal Unemployment Tax. Employers are responsible for withholding employment taxes from employees' pay, and then remitting the employment taxes, as well as the appropriate forms to the IRS for the purpose of revenue collection, and properly crediting a worker's Social Security record.

Charities are a significant part of the economy, and payroll tax compliance by charities is an important part of overall employment tax compliance. According to the GAO, in 2002, charities reported revenues of more than \$941 billion, representing 8 percent of gross domestic product. Their personnel accounted for approximately 8.6 percent of the civilian workforce in 2001. The IRS is responsible for enforcement of all employment tax cases, including those relating to charities and other tax-exempt organizations. The IRS uses a variety of means to find and collect unpaid employment taxes. This hearing will explore whether the IRS uses its significant regulatory authority over charities to ensure that they are meeting their payroll tax obligations.

In order to better understand the extent of payroll tax noncompliance by charities, the Subcommittee has asked GAO to review whether any charities participating in the Combined Federal Campaign (CFC) have outstanding tax debts. The CFC is a program administered by OPM in order to facilitate charitable contributions by federal employees. While all charities receive a tax subsidy, CFC charities receive substantial additional benefits from the Federal Government. The most significant of these benefits is that by accepting a charity in the CFC, OPM is indicating that a charity meets certain basic standards regarding its charitable purpose, transparency and public accountability. Therefore, it is important to see whether these charities

have any outstanding payroll tax debt, and whether the OPM's procedures for reviewing charities' qualifications are effective.

The hearing will examine the following issues:

- What is the IRS doing to ensure that charities comply with their payroll tax obligations?
- Is the IRS effectively using its regulatory authority over charities to ensure that they pay their taxes?
- Is it appropriate for charities with substantial tax debt to maintain their tax-exempt status?
- Do any charities participating in the CFC have tax debt?
- Is it appropriate for charities with tax debt to participate in the CFC?
- Does the OPM perform effective background checks on the charities participating in the CFC?
- Are there tax-exempt organizations with significant tax debt that receive other benefits from the Federal Government, such as grants?

In announcing the hearing, Chairman Ramstad stated, "The Federal Government's fiscal health cannot be maintained without effective employment tax compliance. It is important to ensure that tax deadbeats are not unnecessarily receiving benefits from the Federal Government, whether through tax-exempt status, grants, or promotion in the Combined Federal Campaign."

FOCUS OF THE HEARING:

The hearing will focus on compliance by charities with their employment tax obligations.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, <http://waysandmeans.house.gov>, select "109th Congress" from the menu entitled, "Hearing Archives" (<http://waysandmeans.house.gov/Hearings.asp?congress=17>). Select the hearing for which you would like to submit, and click on the link entitled, "Click here to provide a submission for the record." Once you have followed the online instructions, completing all informational forms and clicking "submit" on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You **MUST REPLY** to the email and **ATTACH** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business Thursday, June 8, 2006. **Finally**, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225-1721.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word or WordPerfect format and **MUST NOT** exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at <http://waysandmeans.house.gov>.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202-225-1721 or 202-226-3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman RAMSTAD. The Committee hearing will come to order. We welcome our witnesses as well as our guests in the audience here today. Nice to see you, Ranking Member Lewis, my dear friend.

Mr. LEWIS. Thank you sir.

Chairman RAMSTAD. The Committee on Ways and Means has been conducting a wide-ranging review of tax-exempt entities to ensure that these tax-exempt entities are providing the benefits that Congress intended in exchange for their tax-exempt status. Today, as part of this ongoing review, we will learn more about whether charities are fulfilling their tax obligations.

While charities do not pay income taxes, they are still responsible for collecting payroll taxes. Given the fact that charities' employees account for 9 percent of the Nation's work force, these payroll taxes are not inconsequential. Therefore, we will hear testimony from the Internal Revenue Service (IRS) which will explain what it does to ensure that charities pay their taxes.

To analyze payroll tax compliance by charities, I asked the government Accountability Office (GAO) to review the charities participating in the Combined Federal Campaign (CFC). The focus on the CFC is appropriate, I believe, as those charities receive additional benefits from the Federal government above and beyond the tax subsidy received by all charities. CFC charities receive, first of all, the Federal Government's seal of approval. They also get extensive promotion and fundraising assistance.

As a result of GAO's work, we learned several disturbing facts. First, a number of CFC charities have Substantial tax debts. The GAO found almost 1,300 CFC charities that owed tax debts, totaling over \$36 million. As detailed in the GAO testimony, some of the charities have been engaged in serious abuse of the Federal tax system. I want to know among other things if the witnesses here today think it is appropriate for charities with substantial tax debts to be participating in the CFC, and if not, what should be done about it?

We also learned pursuant to the GAO review, in addition to participating in the CFC, many of these tax delinquent charities received substantial grants from various Federal agencies totaling \$1.6 billion. That is \$1 billion with a "B" and \$600 million dollars. We learned that the Office of Personnel Management (OPM), apparently does not conduct even the most basic background checks about entities applying to participate in the CFC. For example, the OPM does not even have a list of the charities participating in the

CFC, and despite weeks of work, GAO was never able to get a list of the charities authorized to participate in the CFC. If there is one, we hope to hear about it today, but GAO could not find it.

Perhaps most disturbing of all, we learned that the OPM does not even make sure that charities approved to participate in the CFC are in fact legitimate charities. The GAO applied to three different local CFC campaigns as a fictitious charity in a sting-type operation and was accepted into each of the three campaigns. Again, fictitious charities applying to the CFC campaigns were accepted into all three campaigns. The GAO could have been caught in the sting operation if someone at the local campaign or at OPM had simply picked up the phone and asked the IRS if the applicant were a legitimate if the applicant were a legitimate charity. In fact, GAO's work in this case reminds me of an old Seinfeld episode in which George Costanza sets up a fake charity, called "The Human Fund," with a memorable motto, "money for people," "give to The Human Fund." I see some heads in the audience shaking affirmatively, "give to the human fund," "money for people." George set up his fake charity so that he could tell his coworkers that donations had been made in their name to the Human Fund and thereby avoid giving them actual Christmas presents. While fake charities like The Human Fund might be funny on a sitcom, when it comes to the CFC, they are not a laughing matter.

The OPM procedures appear to be so minimal that anyone could pull a Costanza, create a fake charity and be accepted into the CFC and then use that designation, that imprimatur or aura of legitimacy, to take advantage of donors.

Now, we all know the vast majority of charities in the CFC are established, legitimate, well-intended organizations, and they certainly perform valuable services. It is critical that we not allow the reputations of these charities, of these legitimate organizations, to suffer because of the weak controls that OPM maintains over the CFC.

I am eager to hear more about the GAO's work on this issue, and I am certainly interested in hearing what the OPM and the IRS can do to improve this situation. This situation, these revelations by the GAO, cannot continue. I will now recognize my good friend, the ranking Member, Mr. Lewis.

Mr. LEWIS. Thank you very much, Mr. Chairman, and thank you for holding this hearing today. Let me take just a moment to thank all of the witnesses for being here. The press release for today's hearing asks the overall question: Are charities complying with their employment tax obligations? I think today we will find that the answer is, yes. I look forward to hearing from the witnesses about what the Federal Government can do to ensure even greater compliance with our employment tax laws.

A related issue to be considered by the Subcommittee involves tax law compliance by charities participating in the CFC. The CFC was officially created in 1961 by President Kennedy and has raised more than \$5.5 billion in charitable donations from Federal workers. That is a lot of money on the part of Federal workers. It is the world's largest and most successful workplace giving campaign.

Again, Mr. Chairman, I want to thank you for holding today's hearing because I think it is important that the Subcommittee re-

view these issues. Workers expect that the amounts withheld from their paychecks are correctly sent to the IRS by their employers.

Government employees expect that charitable paycheck contributions are forwarded to first class charity organizations. That is what we need to find out, and I agree, Mr. Chairman, that this is an issue that we must deal with. Thank you very much.

Chairman RAMSTAD. Thank you very much, Mr. Lewis. We will now call our first panel, first and only panel, Gregory Kutz, Managing Director of Forensic Audits and Special Investigations for the U.S. GAO. Welcome, Mr. Kutz. Our second witness will be Mr. Steven T. Miller, Commissioner, Tax Exempt and government Entities (TE/GE) Division of the IRS. Welcome, Mr. Miller. Finally, James S. Green, Associate General Counsel, Compensation, Benefits, Products and Services Group of the OPM. Welcome, Mr. Green. We will begin by hearing from Mr. Kutz, please.

STATEMENT OF GREGORY D. KUTZ, MANAGING DIRECTOR, FORENSIC AUDITS AND SPECIAL INVESTIGATIONS, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Mr. KUTZ. Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to discuss the CFC.

Last year, Federal workers gave \$250 million to CFC charities, helping thousands of people that were in need. Our investigation focused on whether and to what extent these charities had Federal tax problems. The bottom line of my testimony is that the vast majority of CFC charities pay their fair share of taxes. However, we found that 6 percent had \$36 million of unpaid Federal taxes.

My testimony has two parts: first, charity tax problems and, second, oversight of the CFC program. First, we found that 1,280 CFC charities had \$36 million of unpaid Federal taxes. The monitor shows the composition of these unpaid taxes. As you can see, \$28 million represent payroll taxes. Note the payroll taxes include amounts withheld from an employee's wages for Federal income taxes, Social Security and Medicare, along with the employer match. Willful failure to remit payroll taxes is a felony.

Our analysis clearly understates the number of CFC charities with tax problems. For example, our analysis excludes charities that are nonfilers or that underreport payroll or other taxes. Further, in addition to the benefits of CFC, as you mentioned, Mr. Chairman, 170 of these tax delinquent charities received at least \$1.6 billion of Federal grants. Examples of where the grants came from include the Departments of Health and Human Services, Education, Energy, the U.S. Agency for International Development (USAID) and the National Aeronautics and Space Administration (NASA).

In order to determine the story behind these charities and their executives, we investigated 15 that owed between \$100,000 and \$1.5 million of Federal taxes. All 15 charities that we investigated were involved with abusive and potentially criminal activity related to the Federal tax system. For example, rather than fulfill their role as trustees of the payroll tax money and forward it to the IRS, these executives diverted the money for other charity expenses, including their own salaries. Many of these individuals had salaries in excess of \$100,000.

We also found evidence of severe cash flow problems. For example, several of the charities had filed for bankruptcy protection. In other cases, the auditor of the charity had issued what is referred to as a going-concern opinion on the financial statements. This means that the ability of the charity to survive for another year is in serious doubt.

Regarding my second point, OPM and the 300 CFC campaigns do not screen charities for Federal tax problems before allowing them to be listed in the CFC program. Under current law, OPM would need consent from the charities to access IRS tax records. The OPM and the campaigns also do not validate with IRS each CFC applicant's tax-exempt status. To demonstrate the vulnerability of this process, we applied to three CFC campaigns using a bogus charity. The monitor shows one of the three letters that we received this month in response to our application. As you can see, the letter documents the acceptance of our bogus charity into the 2006 CFC. Unlike delinquent tax records, IRS data on tax-exempt status is available to OPM.

In conclusion, our investigation raises several important policy questions. First, should charities with tax problems be allowed to be listed with the CFC? Further, should they be allowed to continue to enjoy their status as tax-exempt organizations and receive Federal grants? Regardless of what policy choices are made, OPM can better ensure the integrity of the CFC program through enhanced oversight. Let us not forget that the vast majority of CFC charities are good corporate citizens that help thousands of those that are truly in need.

Mr. Chairman, this ends my statement. I look forward to your questions.

[The prepared statement of Mr. Kutz follows:]

Statement of Gregory D. Kutz, Managing Director, Forensic Audits and Special Investigations, U.S. Government Accountability Office

Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to assist the subcommittee as it reviews tax-exempt organizations. This testimony builds on our experience investigating entities that have abused the federal tax systemⁱ while benefiting from doing business with the federal government.ⁱⁱ Today, our testimony addresses whether organizations exempt from federal income taxes were delinquent in remitting payroll and other federal taxes to the Internal Revenue Service (IRS) while participating in the 2005 Combined Federal Campaign (CFC).

The CFC, which is administered and promoted by the Office of Personnel Management (OPM) and about 300 local campaigns, gave more than 22,000 charities access to the federal workplace, where they collected more than \$250 million in donations during the 2005 campaign. The success of CFC has made a notable difference in the benefits provided to those in need. The CFC represents that it brings three unique qualities to those it serves—the three C's of CFC—by offering donors a “choice” to select from thousands of charities to support, allowing the “convenience” of mak-

ⁱWe considered activity to be abusive when a 501(c)(3) 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 review of 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.

ⁱⁱSee GAO, Financial Management: Thousands of GSA Contractors Abuse the Federal Tax System, *GAO-06-492T* (Washington, D.C.: Mar. 14, 2006), Financial Management: Thousands of Civilian Agency Contractors Abuse the Federal Tax System with Little Consequence, *GAO-05-637* (Washington, D.C.: June 16, 2005), and Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence, *GAO-04-95* (Washington, D.C.: Feb. 12, 2004).

ing payroll deductions, and ensuring donors' "confidence" that charities listed with the campaign meet CFC's specific eligibility requirements. In the spirit of ensuring that donors can trust their contributions are going to organizations that have met CFC's specific eligibility requirements, and are legitimate charities, you asked us to investigate charities listed with the CFC.

Specifically, you asked us to investigate and determine whether and to what extent (1) charities listed in the 2005 CFC have unpaid payroll and other federal taxes; (2) selected charities, their directors or senior officers are abusing the federal tax system; and (3) OPM screens charities for federal tax problems before allowing them to be listed with the CFC.

As you know, to qualify as exempt from federal income taxes, an organization must meet the requirements set forth in the Internal Revenue Codeⁱⁱⁱ and formally receive tax-exemption designation under 501(c)(3) to participate in the CFC. Regardless of tax-exempt status, all employers are required to withhold from their employees' wages payroll taxes for Social Security and Medicare and other taxes. Willful failure to remit payroll taxes is a felony under U.S. law.^{iv}

To determine whether and to what extent CFC 501(c)(3) charities had unpaid payroll and other federal taxes, we obtained and analyzed IRS unpaid tax debt data as of September 30, 2005. We matched organizations with unpaid tax debts to the CFC's list of charities that participated in the 2005 campaign.^v To further analyze abuse of the federal tax system by selected charities, their directors, or senior officers, we applied certain criteria—the amount of outstanding tax debt, the number and age of reporting periods for which taxes were due, and the type of outstanding tax—to select 15 organizations for detailed audit and investigation. For these 15 organizations, we reviewed tax records and performed additional searches of criminal, financial, and other public records.

To determine whether OPM screens organizations for federal tax problems before allowing them to be listed with the CFC, we identified the legal criteria for doing so and gained an understanding of the screening process through meetings with OPM's Office of CFC Operations and others responsible for processing applications. To test OPM's process of screening for legitimate charities, we created a fictitious charity and applied to three large campaigns in various parts of the country. We also matched the CFC's list of charities that participated in the 2005 campaign against the list of all tax-exempt organizations identified by the IRS to determine whether non-tax-exempt organizations participated in the 2005 campaign. For further details on our scope and methodology, see appendix I.

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

Summary

More than 1,280 CFC charities had tax debts totaling at least \$35.6 million as of September 30, 2005. This represented nearly 6 percent of the charities that participated in the OPM-administered 2005 campaign. Of this debt, \$27.7 million represented payroll taxes, penalties, and interest dating back as far as 1988. The remaining \$7.9 million includes annual reporting penalties, excise taxes, exempt organization business income taxes, unemployment taxes, and other types of taxes and penalties. The majority of the 1,280 delinquent charities, 78.6 percent, owed less than \$10,000 in delinquent taxes. The \$35.6 million in delinquent taxes is likely understated because we took a conservative approach to identifying the amount of tax debt owed to the IRS by CFC charities. The delinquent tax totals do not include amounts for charities that do not file required tax returns and related taxes or charities that underreport unrelated business income or payroll taxes.

In addition to CFC donations, we found that more than 170 of these tax-delinquent charities received about \$1.6 billion in federal grants during fiscal year 2005. Five of 15 case study charities we reviewed in detail were among the more than 170 charities that received federal grants. These 5 charities received grants from the

ⁱⁱⁱ 26 U.S.C. § 501(c)(3).

^{iv} 26 U.S.C. § 7202.

^v The campaign cycle for CFC consists of a 2-year reporting period, which marks the beginning of a campaign and the end of a campaign. Most campaigns will begin operation on or about March 15 of the first year of the campaign and end around March 14 2 years later, depending on the final disbursement for the campaign. For example, March 15, 2005, begins the fall 2005 campaign and March 14, 2007, marks the end of the fall 2005 campaign. Typically, the annual campaign runs for a 6-week period from September 1 through December 15. Actual dates may vary from one campaign to another.

Departments of Health and Human Services (excluding Medicaid) and Education that totaled more than \$6.5 million.

Our detailed audit and investigation of the 15 CFC charities with tax debt and their directors or senior officers identified abusive and potentially criminal activity. Although charities are exempt from certain taxes (e.g., federal income tax), the executives of the 15 charities we investigated were required by law but failed in their roles as “trustees” to forward payroll taxes to the IRS, which include amounts withheld from their employees’ wages for Social Security, Medicare, and the employer’s matching portion of these taxes and individual income taxes.

During interviews, three of the 15 selected charities’ executives denied owing payroll and other taxes when IRS records showed otherwise. Executives from 5 other charities explained that they knowingly withheld payroll taxes in order to have enough funds available to pay for charity activities and the salaries of charity employees. As a result of remitting tax payments late, the charities accumulated tens of thousands of dollars in penalties and interest. Our investigations also showed that several of the executives who potentially could be assessed trust fund recovery penalties for the debts of their charities had salaries in excess of \$100,000 and owned significant personal assets. In addition, according to independent audit reports, some of the charities appeared to have significant cash flow problems. Willful failure to remit payroll taxes is a felony under U.S. law^{vi}. We referred all 15 cases detailed in our report to the IRS so that it can determine whether additional collection action or criminal investigation is warranted.

Neither OPM nor the approximately 300 local campaigns dispersed throughout the United States screen charities for federal tax problems before allowing the charities to be listed with the CFC. OPM policies do not require such screening. Additionally, federal law generally prohibits the disclosure of taxpayer data and, consequently, even if OPM had specific policies to check for unpaid taxes, it has no access to a specific charity’s tax data. The administration of CFC does not have the internal controls necessary to assure donors that charities listed with and backed by the CFC are meeting federal laws.

We also found that OPM, its local campaigns, and federations do not validate with the IRS each CFC applicant’s tax-exempt status. To be eligible for the CFC, a charity must submit as part of its application a copy of a standard IRS letter showing that it has received tax-exemption status from the IRS under 501(c)(3) of the Internal Revenue Code ^{vii} To demonstrate the vulnerability of OPM’s lack of validation of tax-exempt status, we applied as a fictitious charity to three local campaigns using fake documents and an erroneous IRS taxpayer identification number. In all three cases, our fictitious charity was accepted into the local CFC. Furthermore, our match of CFC charities from the 2005 campaign against IRS’s database of tax-exempt organizations identified charities whose 501(c)(3) status could not be confirmed. Therefore, we referred these charities to OPM and IRS for further review and confirmation of their tax-exempt status.

More Than 1,280 CFC Charities Had Tax Debt’s Totaling \$35.6 Million

Based on our analysis, more than 1,280 CFC charities had federal tax debts totaling \$35.6 million as of September 30, 2005. This represented nearly 6 percent of the charities that participated in the OPM-administered 2005 campaign. \$27.7 million of this debt represented payroll taxes, penalties, and interest dating as far back as 1988. The remaining \$7.9 million includes annual reporting penalties, excise taxes, exempt organization business income, unemployment taxes, and other types of taxes and penalties. In performing our analysis, we took a conservative approach to identifying the amount of tax debt owed by the CFC’s charities, and therefore the number of delinquent charities and amount due to the IRS are likely understated. We also found that at least 170 charities with unpaid taxes also benefited by receiving about \$1.6 billion in federal grants.

Unpaid Payroll Taxes Comprised Almost 80 Percent of Charities’ Federal Tax Debt

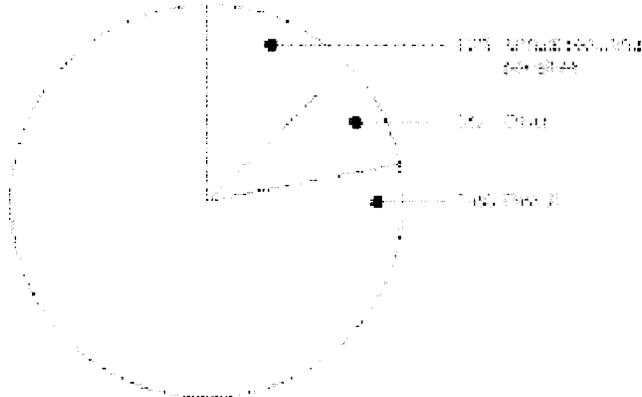
As indicated in figure 1, payroll taxes comprised \$27.7 million, or almost 80 percent, of the \$35.6 million in unpaid federal taxes owed by CFC charities. Unpaid payroll taxes included amounts that were withheld from employees’ wages for fed-

^{vi} 26 U.S.C. § 7202. Under section 7202, it must be shown that a defendant voluntarily and intentionally acted in violation of a known legal duty. *Cheek v. United States*, 498 U.S. 192 (1991).

^{vii} Exempt from this requirement are organizations seeking local eligibility in Puerto Rico or the U.S. Virgin Islands. However, these organizations must include in their applications, the appropriate local forms demonstrating their status as charitable organizations. 5 C.F.R. Pt. 950.204(b)(2)(iii).

eral income taxes, Social Security, and Medicare but not remitted to the IRS, as well as the matching employer contributions for Social Security and Medicare. Employers who fail to remit payroll taxes to the federal government may be subject to civil and criminal penalties. Figure 1 shows the types of federal taxes owed by CFC charities as of September 30, 2005.

Figure 1: Types of Federal Tax Debt Owed by CFC Charities



Source: 2006 Annual Report of the American Farm Bureau Federation, 2006.

The next largest component, annual reporting penalties, was \$4.5 million or almost 13 percent of the unpaid taxes. Generally, the IRS requires 501(c)(3) charities with more than \$25,000 of income to file an annual return (i.e., Form 990). This annual return serves as the basis for review in determining whether an organization continues to meet requirements for exempt status. Failure to file an annual return at all or in a timely manner, as well as filing an incomplete return, results in various types of penalties. Excise taxes related to employee benefit plans, exempt organization business income taxes, unemployment, and other types of taxes and penalties comprised the remaining \$3.4 million.

The majority of the approximately 1,280 delinquent charities, 78 percent, owed less than \$10,000 in delinquent taxes. Fifteen percent owed from \$10,000 to \$50,000, and 7 percent owed more than \$50,000 in delinquent taxes. Also, 91 percent of 1,280 charities were delinquent for up to 4 tax periods, 7 percent of charities for 5 to 9 tax periods, and 2 percent for 10 or more tax periods.^{viii}

Amount of Unpaid Federal Taxes Is Understated for CFC Charities

The amount of unpaid federal taxes we identified among CFC charities—\$35.6 million—is understated. To avoid overestimating the amount owed by CFC charities, we intentionally limited our scope to tax debts that were affirmed by either the charity or a tax court for tax periods prior to 2005.^{ix} We did not include the most current tax year because recently assessed tax debts that appear as unpaid taxes may involve matters that are routinely resolved between the taxpayer and the IRS, with the taxes paid, abated,^x or both within a short period. We eliminated these types of debt by focusing on unpaid federal taxes for tax periods prior to calendar year 2005 and eliminating tax debt of \$100 or less.

Also limiting our estimate of CFC charities' unpaid federal taxes is the fact that the IRS tax database reflects only the amount of unpaid taxes either reported by the charity on a tax return or assessed by the IRS through various enforcement programs. The IRS database upon which we relied exclusively does not reflect amounts owed by charities that have not filed tax returns or that have underreported the

^{viii}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 taxes occurs throughout the quarter. In contrast, for income, corporate, and unemployment taxes, a tax period is 1 year.

^{ix}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.

^xAbatements 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. 26 U.S.C. § 6404.

owed taxes in their return and for which the IRS has not assessed tax amounts due. According to the IRS, underreporting of payroll taxes accounts for about \$60 to \$70 billion of the estimated \$345 billion annual gross tax gap. Consequently, the true extent of unpaid taxes for these charities is unknown.

Some CFC Charities with Delinquent Tax Debt Also Received Substantial Federal Grants

In performing our analysis, we identified at least 170 of the CFC charities with delinquent tax debt that also received federal grants totaling about \$1.6 billion from the Departments of Health and Human Services (excluding Medicaid), Education, and others in 2005. These charities are benefiting from the federal government through their tax-exempt status and receipt of substantial amounts of federal grants, while not meeting their responsibility to pay required federal taxes. Included in the \$1.6 billion are grants to 5 of the 15 charities we selected, totaling more than \$6.5 million.

Certain CFC Charity Executives We Investigated Abused the Federal Tax System

Executives responsible for the tax debts of the 15 charities we investigated abused the federal tax system and may have violated the law by diverting payroll or other taxes due to the IRS. Willful failure to remit payroll taxes is a felony under U.S. law,^{xi} and the IRS can assess a trust fund recovery penalty (TFRP) equal to the total amount of taxes not collected or not accounted for and paid against all individuals who are determined by the IRS to be “willful and responsible” for the non-payment of withheld payroll taxes.^{xii} In this regard, one executive from these 15 case study CFC charities was assessed a TFRP for what IRS determined to be his abusive behavior.

Table 1 highlights 5 of the 15 case study CFC charities that we investigated with payroll tax issues.

Table 1: CFC Charities with Unpaid Federal Taxes

| Charity | Nature of the charity | Tax debt ^a | Comments |
|---------|-----------------------|-----------------------|---|
| 1 | Museum | Over \$100,000 | <ul style="list-style-type: none"> • Payroll tax debt covers more than 12 tax periods dating back to the mid 1990s. • The IRS assessed a TFRP against the charity’s director. • Federal and local tax liens have been filed against the charity. • The charity filed for bankruptcy protection in the past but the court denied the petition. • The executive director admitted to underpaying payroll taxes to fund the charity’s operations. |
| 2 | Hospital | Nearly \$1 million | <ul style="list-style-type: none"> • Payroll tax debt covers more than 5 periods dating back several years. • The charity paid two of its executives a salary of more than \$200,000 each. • The charity received about \$1.5 million in federal grants from the Department of Health and Human Services (non-Medicaid) and the Department of Education. |

^{xi} 26 U.S.C. § 7202.

^{xii} 26 U.S.C. § 6672. The amount of a TFRP does not include employers’ matching amounts.

| Charity | Nature of the charity | Tax debt ^a | Comments |
|---------|-----------------------|-----------------------|---|
| 3 | Mental health clinic | Over \$1.5 million | <ul style="list-style-type: none"> • Payroll tax debt covers more than 12 tax periods dating back to the early 1990s. • The charity recently signed an installment agreement. • Federal, state, and local tax liens have been filed against the charity. • The executive director received a salary of more than \$100,000. • The executive director admitted to underpaying payroll taxes to fund the charity's operations, which includes the director's salary. |
| 4 | Homeless shelter | Over \$300,000 | <ul style="list-style-type: none"> • Charity failed to submit payroll tax payments for more than 5 tax periods over several years. • The executive director received a salary of more than \$100,000 per year. |
| 5 | General health clinic | Over \$700,000 | <ul style="list-style-type: none"> • Payroll tax debt covers 7 tax periods dating back over 5 years. • The charity submitted an offer in compromise, which is pending. • The chief executive officer received a salary of more than \$100,000 per year. |

Source: GAO's analysis of IRS, OPM, public, and other records.

^aTax debt amount includes principal, interest, and penalties as of September 30, 2005.

For the five charities in table 1, tax debt ranged from about \$100,000 to more than \$1.5 million, and the unpaid taxes spanned a period ranging from 5 to more than 12 payroll tax periods. In addition to the federal tax debt, two of the five CFC charities had unpaid state and/or local taxes, where state and/or local taxing authorities filed multiple tax liens against them.

During the time frames for which these charities were not paying their taxes, funds were available to cover other charity expenses, including officer salaries. Executives at two charities explained that they knowingly withheld payroll taxes in order to have enough funds available to pay their own salaries and the salaries of charity employees, in addition to charity expenses. One executive we investigated denied owing payroll or other taxes when IRS records showed otherwise. In at least one case, the charity's executives remitted payroll taxes later than the IRS required to pay their salaries, while the charity accumulated tens of thousands of dollars in penalties and interest for remitting late.

We also identified directors and senior executives who potentially could be assessed TFRPs by the IRS for the debts of their charities. Some of these directors and executives had salaries in excess of \$100,000 and owned significant personal assets. One of these executives has already been assessed a TFRP.

See appendix III for the details on the other 10 CFC charities reviewed in detail. We referred all 15 cases discussed in our report to the IRS so that it can determine whether additional collection action or criminal investigation is warranted.

OPM Does Not Screen Charities for Delinquent Tax Debt

OPM does not screen charities for federal tax debt prior to granting CFC eligibility, thereby making charities with unpaid federal taxes eligible to receive donations from federal civilian employees and military personnel. OPM policies do not specifically require CFC charities to be screened for these problems. Additionally, federal law generally prohibits the disclosure of taxpayer data and, consequently, even if OPM had specific policies to check for unpaid taxes, it has no access to a specific charity's tax data. OPM determines the completeness of a charity applicants' paperwork, but it does not perform third-party verification of documents as part of that process. For example, OPM does not verify with the IRS the tax-exempt status of CFC applicants and relies solely on each applicant's submission of IRS documentation that it is a bona fide charity. To demonstrate the vulnerability of OPM's lack of validation of tax-exempt status, we applied to three of CFC's largest local 2006 campaigns using a fictitious charity with entirely false documents and an erroneous IRS taxpayer identification number. We were accepted into all three campaigns.

Tax Debt Are Not Considered When Granting Charities Eligibility to Participate in the CFC

OPM does not screen charities for tax debts prior to granting CFC eligibility and, ultimately, charities with unpaid federal taxes are eligible to receive donations from federal civilian employees and military personnel. Federal law implemented in the Code of Federal Regulations does not require OPM to screen charities for federal tax delinquency nor does it explicitly authorize CFC to reject charity applicants that have delinquent tax debt from participation in the CFC. Consequently, CFC's processes for determining eligibility are based on and limited to what is required of the CFC in Part 950 of Title 5, C.F.R.

Restrictions on Tax Debt Hamper Identification of Charities with Delinquent Taxes

Federal law does not permit the IRS to disclose taxpayer information, including tax debts.^{xiii} Thus, unless the taxpayer provides consent, certain tax debt information can only be discovered from public records when the IRS files a federal tax lien against the property of a tax debtor.^{xiv} However, public record information is limited because the IRS does not file tax liens on all tax debtors, and, while the IRS has a central repository of tax liens, OPM officials do not have access to that information. Further, the listing of a federal tax lien in the credit reports of an entity or its key officials may not be a reliable indicator of a charity's tax indebtedness because of deficiencies in the IRS's internal controls that have resulted in the IRS not always releasing tax liens from property when the tax debt has been satisfied.^{xv}

OPM Does Not Verify Charity Applicant's Exempt Organization Status

Part 950 of Title 5 of the Code of Federal Regulations requires that applicants to the CFC include in their application packages a copy of their most recent IRS determination letter^{xvi} showing the charity's 501(c)(3) status. OPM does not perform any independent verification of charity applicants' tax-exempt status. The IRS does have publicly available data wherein OPM could verify an applicant's tax exempt status, but this is not an OPM-required procedure in the CFC eligibility determination process. Other documents OPM requires applicants to include in the CFC application package are a copy of the charity's most recent form 990, their most recent annual audit report, and an application with various self-certifications. According to an official from one of the CFC's largest local campaigns, the single most frequent reason for rejecting an applicant from the CFC is the applicant's failure to submit its IRS determination letter.

Control Weaknesses Allowed GAO to Enroll Fictitious Charities

To determine whether and to what extent CFC's eligibility determination processes are vulnerable, we applied to three local campaigns with a fictitious charity using fake documents and an erroneous IRS taxpayer identification number. In all three campaigns, our application for participation in the 2006 CFC was accepted. Figure 2 shows one example of the three letters we received regarding our acceptance into the 2006 CFC. Immediately after our applications were accepted, we notified CFC officials and withdrew our charity from the campaigns in order to prevent donations to our fictitious charity.

In addition to our direct testing of OPM's screening process, our match of CFC charities from the 2005 campaign against IRS's database of tax-exempt organizations identified charities whose 501(c)(3) status could not be confirmed. Therefore, we referred these charities to OPM and IRS for further review and confirmation of their tax-exempt status.

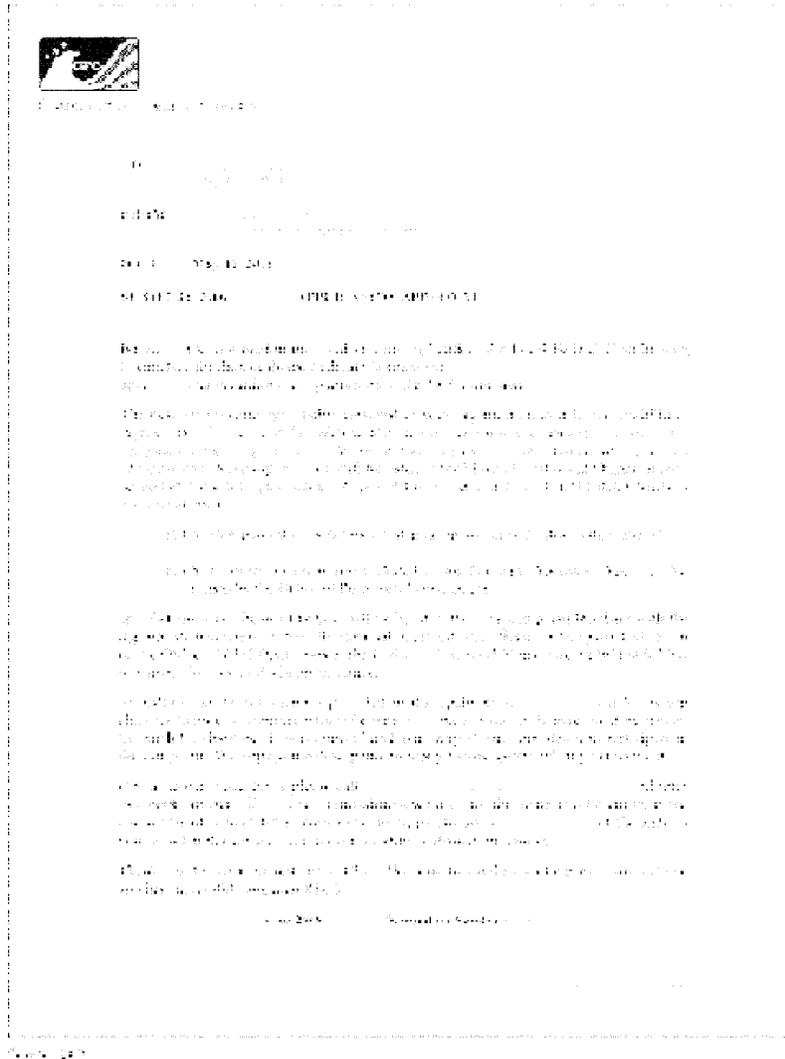
^{xiii} 26 U.S.C. 6103.

^{xiv} Under section 6321 of the Internal Revenue Code, IRS has the authority to file a lien upon all property and rights to property, whether real or personal, of a delinquent taxpayer.

^{xv} GAO, IRS Lien Management Report: Opportunities to Improve Timeliness of IRS Lien Releases, GAO-05-26R (Washington, D.C.: Jan. 10, 2005).

^{xvi} A determination letter to an organization is the IRS's notification that it has reviewed the organization's application package and qualified it as exempt from federal income taxes.

Figure 2: Copy of an Acceptance Letter from One of the Three Local CFC Campaigns for Our Fictitious Charity



Concluding Observations

The success of the OPM's CFC is predicated on each donor's confidence in a system that ensures that their donations reach charitable organizations that have met the CFC's specific eligibility requirements and are legitimate charities. The bona fide charities participating in the annual campaign have the most to lose when such confidence is shaken because of the abuse of a minority of participating charities. Until OPM takes steps to independently validate whether applicants are legitimate 501(c)(3) organizations, the campaign is vulnerable to entities that fraudulently purport to be charities. Further, tax-abusing charities will continue to benefit by being eligible to participate and receive donations unless OPM is provided access to their tax debt information and determines whether sanctions such as expulsion from the CFC are warranted. OPM and each local CFC cannot provide the assurance needed to sustain such confidence. This could have devastating consequences for the vast

majority of eligible and tax-compliant charities that are dependent on donor contributions to support their critical missions.

Mr. Chairman and Members of the Subcommittee, this concludes my statement. I would be pleased to answer any questions that you or other members of the committee may have at this time.

Appendix I: Objectives, Scope, and Methodology

Our objectives were to investigate and determine whether and to what extent (1) charities listed in the 2005 Combined Federal Campaign (CFC) have unpaid payroll and other federal taxes; (2) selected charities, their directors, or senior officers are abusing the federal tax system; and (3) the Office of Personnel Management (OPM) screens charities for federal tax problems before allowing them to be listed with the CFC.

To determine whether any of the charities listed in the 2005 CFC have unpaid payroll and other federal taxes, we first identified charities that participated in the 2005 campaign. To identify CFC charities we requested data from CFC headquarters. To obtain these data, CFC headquarters requested data from the 299 local campaigns throughout the United States. We received data from 291 of the 299^{xvii} local campaigns.

To identify CFC charities with unpaid federal taxes, we obtained and analyzed the Internal Revenue Service's (IRS) September 30, 2005, Unpaid Assessments file. We matched the CFC charity data to the IRS unpaid assessment data using the taxpayer identification number (TIN) field. To avoid overstating the amount owed by charities 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 the IRS classified as compliance assessments or memo accounts for financial reporting,^{xviii}
- tax debts from calendar year 2005 tax periods, and
- charities 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 duplicative of other taxes already reported. We excluded tax debts from calendar year 2005 tax periods to eliminate tax debt that may involve matters that are routinely resolved between the taxpayers and the 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 CFC charities.

The 2005 pledged donation (pledges) information was unavailable at the time we selected our charity cases for investigations. We requested pledge information from the CFC and were in the process of receiving these data, piecemeal, from the CFC's 299 campaigns as of the end of our fieldwork. The pledge information we received through the end of fieldwork lacked the detail necessary to efficiently determine the amount of pledges for tax-delinquent charities. Consequently, we were unable to determine the amount of pledges received for tax-delinquent charities we identified.

To determine whether selected charities, their directors, or senior officers are abusing the federal tax system, we selected 15 charities for a detailed audit and investigation. We selected the 15 charities using a nonrepresentative selection approach based on our judgment, data mining, and a number of other criteria, including the amount of unpaid taxes, number of unpaid tax periods, amount of payments reported by the IRS, and indications that key officials might be involved in multiple charities with tax debts.

We obtained copies of automated tax transcripts and other tax records (for example, revenue officers' notes) from the IRS as of September 30, 2005, and reviewed these records to exclude charities that had recently paid off their unpaid tax balances and considered other factors before reducing the selection of charities to 15 case studies. For the selected 15 cases, we reviewed the charity CFC application

^{xvii} Data from the remaining 8 local campaigns were either not received or not sufficient for analysis.

^{xviii} Under federal accounting standards, unpaid assessments require taxpayer or court agreement to be considered federal taxes receivables. Compliance assessments and memo accounts are not considered federal taxes receivable because they are not agreed to by the taxpayers or the courts.

files and performed additional searches of criminal, financial, and public records. Our investigators also contacted several of the charities and conducted interviews.

To determine whether and to what extent OPM screens charities for federal tax problems before allowing them to be listed with the CFC, we reviewed OPM's policies and procedures, performed process walkthroughs, and interviewed key CFC officials at CFC Headquarters and three local campaigns. We reviewed laws and regulations governing OPM's administration of the CFC. We identified processes and procedures performed by the CFC during the annual application period. To confirm our understanding of the requirements placed on charity applicants and to test whether OPM's processes would identify fraudulent charities, we attempted to gain acceptance into the 2006 CFC by posing as a charity. We prepared and submitted application packages for each of three local campaigns using fake documentation for a fictitious charity. To test the effectiveness of OPM's processes and procedures to identify charity applicants that are not valid tax-exempt organizations, a primary requirement for participation in the CFC, we matched the list of CFC charities that participated in the 2005 campaign with the IRS's database of tax-exempt organizations.

We conducted our audit work from January 2006 through May 2006 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 the IRS unpaid assessments data, we relied on the work we performed during our annual audits of the 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 the IRS's tax records, including errors and delays in recording taxpayer information and payments, we determined that the data were sufficiently reliable to address this testimony'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 CFC-provided data, we performed electronic testing of specific data elements in the databases that we used to perform our work and performed other procedures to ensure the accuracy of the charity data provided by the CFC.

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 testimony were sufficiently reliable for our purposes.

Appendix II: Background

The Combined Federal Campaign (CFC) is the only authorized solicitation of employees in the federal workplace on behalf of charitable organizations. The CFC's mission is to promote and support philanthropy through a program that provides all federal employees the opportunity to improve the quality of life for others through donations to eligible nonprofit organizations. In 1971, the CFC began operation as a combined campaign with donations solicited once a year. Also during this period, charitable contributions in the form of payroll deduction were made possible. Contributions grew dramatically from \$12.9 million in 1964 to \$82.8 million in 1979. Growth in the number of participating charities was slow through the 1970s, increasing from 23 charities in 1969 to only 33 charities in 1979. Significant changes in CFC regulations occurred in the late 1970s and early 1980s^{xix} which in April 1984 opened the CFC to organizations that received tax-exempt status under 501(c)(3) of the Internal Revenue Code. The CFC has grown to a campaign consisting of approximately 1,700 (2005 campaign) national and international charitable organizations and more than 21,000 local charities. Contributions have also increased from about \$95 million in 1981 to more than \$255 million in 2004.

Each campaign is conducted during a 6-week period, varying by local campaign from September 1 through December 15, at every federal agency in the campaign community. During this period, current federal civilian and active duty military employees, throughout the country and internationally, donate tens of millions of dollars to these nonprofit organizations that provide health and human service benefits throughout the world.

The Director of the Office of Personnel Management (OPM) exercises general supervision over all operations of the CFC and takes steps to ensure the campaign

^{xix}Including a court order that prohibited OPM from excluding legal defense and advocacy groups from the CFC because of their "indirect" support of health and welfare or their lobbying/advocacy activities.

objectives are achieved. The CFC is decentralized; therefore, each of the approximately 300 campaigns manages its local campaign and then reports statistics in aggregate to OPM. The Local Federal Coordinating Committee (LFCC) is the leadership element of the local CFC and is comprised of members from the federal community—federal civilian, military, and postal. The LFCC solicits annually a principle combined fund organization (PCFO), conducts local agency eligibility, approves campaign material, conducts compliance audits, is the liaison to federal agency heads, and is generally engaged in a host of the scheduled campaign activities. The PCFO manages all aspects of the campaign. The PCFO develops campaign materials; serves as fiscal agent; collects, processes, and distributes pledges; and trains loaned executives and campaign personnel. The PCFO and the LFCC are responsible for reporting to the OPM summary data about their campaign results.

Appendix III: CFC Charities with Unpaid Taxes

Table 1 in the main portion of this testimony provides data on 5 detailed case studies. Table 2 shows the remaining case studies that we audited and investigated. As with the 5 cases discussed in the body of this testimony, for all 10 of these case studies we found abuse or potentially criminal activity related to the federal tax system. All 10 charities in table 2 had unpaid payroll taxes.

Table 2: CFC Charities with Unpaid Federal Taxes

| Charity | Nature of charity | Tax debt ^a | Comments |
|---------|---|-----------------------|---|
| 6 | Rehabilitation services | Over \$100,000 | <ul style="list-style-type: none"> The charity failed to pay its payroll taxes in full or on time, resulting in delinquent payroll taxes and subsequent interest and penalties. A federal tax lien has been filed against the charity. Although these taxes remain outstanding, one of the executives of this charity recently placed property into a family trust. |
| 7 | Psychiatric center | Over \$1 million | <ul style="list-style-type: none"> This entity owes more than \$600,000 in penalties and interest. A state tax lien of \$200,000 has been filed against the charity. The charity repeatedly underpaid payroll taxes in 1 year recently. Executive director received a salary of more than \$100,000. A recent independent auditor's report states there is substantial doubt regarding the entity's ability to continue operating (i.e., a going concern). An officer of the charity told us that rather than remitting the payroll taxes to the IRS, the officer used them to pay operating expenses, which included the officer's own salary. |
| 8 | Healthcare provider of hospital and nursing home services | Over \$400,000 | <ul style="list-style-type: none"> Federal tax lien has been filed against the charity. The charity filed for Chapter 11 bankruptcy protection. The top executives of the charity and several part-time management personnel were employed through a contracting firm and were paid wages that totaled more than \$3 million. The charity received over \$2 million in grants from the Department of Health and Human Services. |
| 9 | Drug and alcohol rehabilitation center | Over \$70,000 | <ul style="list-style-type: none"> The charity has substantial equity in a multi-acre parcel of real estate located in a major metropolitan area. The charity owns a boat that is primarily used by the executive director. |

| Charity | Nature of charity | Tax debt ^a | Comments |
|---------|--|-----------------------|---|
| 10 | Charity provides social welfare programs | Nearly \$300,000 | <ul style="list-style-type: none"> • A recent independent auditor's report states there is substantial doubt regarding the entity's ability to continue operating (i.e., a going concern). • The charity received federal grants of more than \$2.5 million from the Department of Health and Human Services. |
| 11 | Social services for the blind | Nearly \$100,000 | <ul style="list-style-type: none"> • The charity has more than 13 periods of payroll tax debt dating back several years. • The charity entered into an installment agreement that the IRS terminated after the charity did not make the required payments. |
| 12 | Prevent and treat child abuse | Over \$120,000 | <ul style="list-style-type: none"> • Charity owes over \$120,000 in payroll taxes, penalties and interest from the late 1990s. • Charity requested an offer in compromise on the tax debt. • State and local tax liens have been filed against the charity's real estate. • After the charity was delinquent in paying its payroll taxes, it obtained more than \$600,000 to construct a new building. • An officer of the charity told us that rather than remitting the payroll taxes to the IRS, the officer used them to pay the charity's workers, which included the officer's own salary. • The charity received federal grants of \$40,000. |
| 13 | Counseling service for adults, adolescents, and children | Over \$500,000 | <ul style="list-style-type: none"> • The charity's tax debt covers more than six tax periods. • Charity paid consultant more than \$100,000 for professional services. |
| 14 | Adult and senior services | Nearly \$200,000 | <ul style="list-style-type: none"> • Federal tax lien has been filed against the charity. • The charity received federal grants of \$140,000. |
| 15 | Family social services | Over \$500,000 | <ul style="list-style-type: none"> • The charity's tax debt covers more than 20 tax periods of payroll taxes. • Federal tax lien has been filed against the charity. • An officer of the charity told us that rather than remitting the payroll taxes to the IRS, the officer used them to pay operating expenses, which included the officer's own salary. |

Source: GAO's analysis of IRS, OPM, public, and other records.

^aTax debt amount includes principal, interest, and penalties as of September 30, 2005.

Chairman RAMSTAD. Thank you, Mr. Kutz. Mr. Miller, please.

STATEMENT OF STEVE T. MILLER, COMMISSIONER, TAX-EXEMPT AND GOVERNMENT ENTITIES DIVISION, INTERNAL REVENUE SERVICE

Mr. MILLER. Thank you, Mr. Chairman, Ranking Member Lewis and Members of the Subcommittee.

To encourage employment tax compliance by tax-exempt entities, the IRS begins with customer education outreach and follows up with document matching, examinations, collections and other tradi-

tional forms of enforcement. We start with an expansive educational effort. Our exempt organizations function conducts workshops and maintains numerous publications and an active Internet Web site on the topic. Our enforcement efforts are best understood by dividing the discussion into two categories: First is the Combined Annual Wage Reporting System (CAWR), and its related programs. Second is the examination program run out of my organization, TE/GE. Now, ideally, form 941 and similar returns we receive should match forms W-2 and W-3 that Social Security Administration (SSA) receives. To verify this, the CAWR program matches reported earnings and reported withholding of taxes. To reconcile differences, the IRS, working with SSA, maintains three programs. The first two, SSA CAWR and IRS CAWR, deal with instances where the agency actually has received all returns, but there is a mismatch in the information. The third program deals with instances where it appears that the IRS does not have a form 941 to match with the SSA data. Under the first two programs for 2004, mismatch issues related to almost 30,000 TE/GE taxpayers were pursued. We estimate that about 20,000 of these were section 501(c)(3) organizations. The third CAWR program identifies and refers to the potential 941 non-filers. The TE/GE receives around 4,000 CAWR referrals per year, substantially comprised in terms of dollars of governmental entities and pension plans. Since 2001, the potential value of tax owed by referred TE/GE entities has declined dramatically from \$1.29 billion in 2001 to \$180 million in 2004. Of the \$180 million, \$17 million relates to 501(c)(3) organizations.

Our Exempt Organization Examination Process (EO) function has pursued form 941 non-filers not through the CAWR system in actuality but through a different program that matches 941s to the charities form 990. So, where compensation exceeds a certain amount as reported on the 990 but no 941 was found, we have conducted more than 800 examinations in recent years to resolve that issue. However, few improper non-filers were found. We have actually recently discontinued this program while continuing to look for better ways to select cases. As part of this effort, this winter, we will begin to pilot a new computer-based modeling system to select better cases including those in the employment tax area. Outside of CAWR and similar programs, the examination of exempt organizations for employment tax is integrated otherwise into our EO General Examination Program, and it is within this structure that the great majority of our examinations are conducted. We do about 1,200 of these per year.

Beyond our document matching and examination programs is the collection program. In determining whom to pursue in the collection process, charities are treated like any other taxpayer. As a result, in the collection area, the numbers I have that I can use today relate to all TE/GE taxpayers and all taxes, not just charities and not just employment tax. For example, I can say that, in 2005, a total of 282,000 first notices were issued to TE/GE taxpayers generally. A little over half were resolved by the taxpayer's self-correction during this notice process. Only about 27,000 TE/GE taxpayers continued past the notice phase in 2005 for potential contact by either a revenue agent knocking on the door or through one of our

call sites. As stated, whether or not these get worked is determined by criteria that are not TE/GE specific.

Let me wind up by stating that the IRS has a credible and considered program for enforcing the employment tax laws that apply to charities. While the law does not generally contemplate the revocation of a charity's tax-exempt status for failure to comply fully with employment tax law, it does give us other tools to insist that charities meet their employment tax obligations, and we have an active program in place to do just that. Thank you.

[The prepared statement of Mr. Miller follows:]

Statement of Steven T. Miller, Commissioner, Tax-Exempt and Government Entities Division, Internal Revenue Service

I. Introduction

Chairman Ramstad, Ranking Member Lewis and members of the Subcommittee, I appreciate the opportunity to testify this morning on the Internal Revenue Service's enforcement efforts with respect to charities' payment of employment taxes.

I am the Commissioner, Tax Exempt and Government Entities (TE/GE). TE/GE is one of four operating divisions at the IRS. We have principal responsibility for tax-exempt entities. In addition to the charities that are the subject of today's hearing, we are also responsible for other tax-favored entities: qualified retirement plans, all types of tax-exempt organizations, tax-exempt bonds, Indian tribal governments, and federal, state and local governments in their role as employers, which makes them responsible for employment taxes.

In addition to discussing what my division, TE/GE, does to enforce the law with respect to charities' employment tax obligations, I will also discuss this morning the role played by another of our operating divisions in detecting and collecting employment taxes from charities. This is the Small Business/Self Employed division (SB/SE). As will be apparent, SB/SE plays a major role within the IRS in enforcing the tax law as it relates to employment taxes.

The IRS appreciates your focus on complete compliance, with all aspects of the tax law, by all classes of taxpayers, including those designated as "tax-exempt." Even charities and tax-exempt entities have employment tax obligations, a point I will elaborate on in a moment. Commissioner Everson has established the enhanced enforcement of the tax law as one of the three goals of his tenure as Commissioner of Internal Revenue. Further, he has specifically identified, as a principal objective of this goal, the task of deterring abuse within tax-exempt and governmental entities and the misuse of such entities by third parties for tax avoidance or other unintended purposes.

In furtherance of these goals, the Commissioner has, in recent years, requested additional resources for enforcement generally. Within TE/GE, we have concentrated the new resources we have received in two of our functions, Exempt Operations (EO) and Federal, State and Local Governments (FSLG). In FY 2001, we had 812 FTE in EO and 50 FTE in FSLG. In 2005, those numbers had increased to 845 and 100, respectively. EO and FSLG are the functions in TE/GE where we most often address employment tax issues. We have also used these resources to address a number of serious problems within the tax-exempt sector. These include, for example, the abuse of tax-exemption by credit counseling organizations, the practice of executives of some charities awarding themselves excessive compensation packages, and the improper intervention by charities in political campaigns.

This morning, I would like to begin with an overview of the law governing employment tax, with an emphasis on how it applies to exempt organizations. Next, I will discuss the IRS's enforcement and collection efforts in this area. In doing so, I will discuss the Combined Annual Wage Reporting program (CAWR), which involves cooperation between the Social Security Administration (SSA) and SB/SE. I will also discuss TE/GE specific programs that address employment tax among tax-exempt and governmental entities. Finally, I will briefly speak of our future plans for enforcement in this area.

II. Applicable Law

Overview of Employment Tax Requirements

Let me begin with the applicable law. What follows in this section of my testimony is a broad discussion of the main employment tax obligations imposed on employers. There are many specific details and exceptions that affect the amount of an employer's liability and how the employer goes about reporting and paying the tax.

In general, employers are required to pay employment taxes on wages, and to report wages and certain other payments to the IRS. Federal employment taxes include three components: (i) federal income tax withholding, (ii) social security, and Medicare taxes (the Federal Insurance Contributions Act "FICA" taxes), and (iii) the Federal Unemployment Tax Act (FUTA) tax. Employers are required to make deposits of employment taxes on a daily, semi-weekly, monthly or quarterly schedule, depending upon the amount of tax they accumulate for deposit.

For purposes of today's discussion, it is important to note that charities described in section 501(c)(3) that are exempt from income tax under section 501(a), as well as Federal, state and local government agencies and instrumentalities, are not liable for taxes under the FUTA. This is a significant distinction from other employers.

Determining Liability for Tax

The first step in evaluating liability for federal employment taxes is to determine whether a worker is an employee or an independent contractor. The Code applies the multi-factor common law test for this purpose. Under the common law test, an employer-employee relationship exists when the person for whom the services are performed has the right to control and direct the individual who performs them. More detailed information is available in *Independent Contractor or Employee? Training Materials* (1996), issued by the IRS and available on the IRS web site at <http://www.irs.gov/pub/irs-utl/emporind.pdf>. Employers are generally liable for employment taxes, and the associated withholding, reporting and deposits, on the wages they pay their employees.

Employers are also required to withhold and pay the employee portion of social security taxes (currently 6.2 percent of wages up to the maximum wage base, which is \$94,200 for 2006) and Medicare taxes (currently 1.45 percent of all wages) from payments of wages, and to pay the equivalent employer portion of social security and Medicare taxes with respect to wages paid to the employees. If the employer fails to withhold the proper amount of income tax or the employee portion of social security or Medicare taxes from wages paid to the employee, the employer remains liable for such tax.

The law provides exceptions from the general rules for certain employers. We will discuss the special rules for charities below, but will first note that there are also special rules that apply to governments. For example, state and local government workers are not subject to social security tax if they are otherwise covered by a retirement system providing a benefit similar to social security. A state or local government employee will be exempt from the Medicare tax if the employee has been continuously employed by the same employer since 1986, and is also covered by a retirement system. Additionally, Federal employees hired before January 1, 1984, are generally not subject to social security tax. These exceptions do not apply for purposes of income tax withholding.

How employment tax is paid

Employers are required to withhold income tax from wages in accordance with tables provided by the IRS and published in Publication 15, Circular E, and Employer's Tax Guide, which is updated at least annually and is found at the following URL: www.irs.gov/pub/irs-pdf/p15.pdf. If the employer fails to withhold income tax, and the employee does not pay the income tax, the employer remains liable for the missing withholding.

In general, employers must pay federal employment tax by depositing federal income tax withholding and both the employer and employee social security and Medicare taxes. In calculating the amount to be deposited the employer must take into account any adjustments to tax liability for prior periods and the amount of any advance earned income credit payments. The liability for employment tax arises when the wages are paid. If an employer accumulates \$100,000 or more of employment tax liability, the employer must deposit the employment taxes by the end of the next business day. Less frequent deposits are required for smaller liabilities. Some employers are required to deposit using the Electronic Federal Tax Deposit System (EFTPS).

Filing of Tax Returns and Information Reporting

In addition to determining the liability for employment taxes and making timely deposits, employers are responsible for filing appropriate tax and information returns. Employers are required to file Form 941, Employer's Quarterly Federal Tax Return, reporting liability for Federal income tax withholding, social security, and Medicare tax on a quarterly basis. Beginning January 1, 2006, employers with an estimated annual employment tax liability of \$1,000 or less may file the new Form 944 (Employers Annual Federal Tax Return) once a year rather than filing Form 941 four times a year. The IRS mailed notification letters between February 1 and February 15, 2006 to eligible small employers for calendar year 2006.

Employers must also provide each employee with a copy of his Form W-2 for the preceding year by January 31. Employers are required annually to file Form W-3, Transmittal of Wage and Tax Statements, with the Social Security Administration along with copies of the Forms W-2 for all employees.

All taxpayers are required to maintain the records necessary to support the information submitted on their tax returns. If an employer discovers that it has made a mistake in computing its social security and Medicare tax liability in a prior tax return, IRS procedures call for the employer to amend its returns and pay any social security and Medicare taxes that it owes. Under Code section 6205, adjustments related to the FICA tax are made "interest free" on a subsequent Form 941 with an attached Form 941C explaining the adjustment. Generally, this rule applies for errors related to income tax withholding only if the error is discovered within the same calendar year.

IRS procedures also call for the employer to provide the employee with a corrected Form W-2.

Personal liability for employment taxes

Section 6672(a) of the Code imposes a liability equal to the amount of unpaid "trust fund taxes" upon any person responsible for collecting, accounting for or paying over such taxes who willfully fails to do so. "Trust fund taxes" include income tax withholding and the employee portion of social security and Medicare taxes.

Special Rules Applicable to Exempt Organizations

If an exempt organization has employees, it is responsible for federal, state, and local taxes. Exempt organizations follow the same employment tax filing and reporting requirements as non-exempt organizations, with two exceptions. The first applies to exempt organizations that are exempt from income tax under section 501(c)(3) of the Internal Revenue Code. Such an organization is also exempt from FUTA. This exemption cannot be waived.

The second exception applies to churches, and concerns all three employment taxes: withholding, FICA and FUTA.

Churches are not required to withhold income tax on compensation paid to ministers for performing services in the exercise of their ministry, although a minister may request voluntary income tax withholding. Whether tax is withheld or not, the church reports the minister's compensation on Form W-2, if the minister is an employee, or on Form 1099, if the minister is an independent contractor. If the minister is the only employee, the church may have no form 941 requirement.

Churches are required to withhold income tax for their other employees, and the general rules apply for determining whether a worker providing services is an employee or an independent contractor. The Church reports an employee's compensation on Form W-2, or issues a Form 1099 for an independent contractor.

Churches are also not required to withhold or pay FICA taxes on compensation paid to ministers for performing services in the exercise of their ministry. However, a minister is subject to SECA, unless he or she applies timely for an exemption on the basis of his or her religious beliefs.

Other church employees are subject to FICA unless the church pays the employee less than \$108.28 in a calendar year or the church applies for an exemption from FICA due to religious reasons. If a church makes such an election not to pay FICA, the employees are subject to SECA.

Churches, like other 501(c)(3) organizations, are not subject to the FUTA tax for any of their employees.

Is Failure to Pay Employment Tax a Cause for Revocation of Tax-Exempt Status?

Under section 508 of the Code, a charitable organization wishing to obtain tax-exempt status, must apply to the IRS for exemption. These applications come to TE/GE's EO unit, where they are reviewed. If the applicant demonstrates its eligibility for exemption, we issue it a determination letter recognizing its tax-exempt status.

Under section 508(c), churches, their integrated auxiliaries, and conventions or associations of churches are not required to complete this determination process.

Exempt status, once recognized, can be lost. The IRS is authorized to, and does, revoke the tax-exempt status of organizations that cease to act in pursuance of an exempt purpose, or that violate specific provisions of the Code pertinent to tax-exempt status. For example, section 501(c)(3) prohibits, among other things, inurement or participation or intervention in political campaigns. As I mentioned a moment ago, TE/GE is conducting enforcement programs aimed at organizations that violate these prohibitions.

Compliance with employment tax rules is not, in general, a requirement for continuing recognition as a tax-exempt organization. In exceptional circumstances, revocation of section 501(c)(3) exempt status for violation of employment tax provisions, while an extraordinary measure, may be warranted where the violation of employment tax law is so substantial that the organization can be found to have a substan-

tial non-exempt purpose. Available records do not indicate that we have revoked the tax-exempt status of any organization solely because of employment tax non-compliance.

The facts of the case would be critical in any case where such a revocation was contemplated. For example, if the unpaid employment taxes are being pocketed by individuals for their personal enrichment, it is likely that a private benefit or inurement issue is present that may warrant revocation. However, if the organization does not pay the employment taxes because the organization is short of money and chooses to use that which it has to meet net payroll and to further its exempt purpose, then the failure to pay may not rise to the level of a violation of the operational test.

III. IRS Compliance Efforts Directed at Charities

As I noted in the introduction, two operating divisions of the IRS are primarily responsible for enforcing the payment of federal employment taxes by charities: SB/SE and TE/GE.

To encourage and enforce compliance by tax-exempt entities with the requirements of employment tax law, we begin with customer education and outreach and follow-up with document matching, examinations, collections, and traditional forms of enforcement. I'd like to begin this portion of my testimony by discussing TE/GE's customer education and outreach programs for tax-exempt entities, and then move to a discussion of IRS enforcement efforts.

A. Outreach and Education.

Exempt Organizations

TE/GE's Exempt Organizations (EO) function conducts a vigorous customer education and outreach program to educate charities and other exempt organizations about their tax responsibilities, including their employment tax obligations. This effort is especially important for small and mid-sized organizations, whose officials may not be experienced in business operations. EO includes information about employment tax obligations in its plain language publications, notably Publication 4221, *Compliance Guide for 501(c)(3) Tax-Exempt Organizations*, Publication 1828, *Tax Guide for Churches and Religious Organizations*, and Publication 557, *Tax-Exempt Status for Your Organization*. EO also addresses employment taxes in workshops and via the internet.

For example, in EO's Small and Mid-sized Exempt Organizations Workshop program, offered in six cities across the country each year, we include a session on Employment Taxes as one of five parts of the day-long workshop. The session has three objectives:

- Identify the main factors used to categorize a worker as either an employee or an independent contractor;
- Identify the workers that are statutorily classified as employees and those that are statutorily classified as independent contractors; and
- Introduce the major employment tax forms and their uses for the typical small EO.

During the presentation, attendees participate in an Employment Issues Quiz, which reviews the concepts covered in the session. Each attendee also receives a copy of the Small and Mid-sized EO Workshop Textbook, which includes a chapter on Employment Taxes. Next year, we will also make those workshops available on a CD, while continuing to offer the program in certain cities.

With respect to the internet, employment taxes are a prominent component of the interactive "Life Cycle of a Public Charity" and "Life Cycle of a Private Foundation" features that appear on EO's external web page. The Life Cycle features are easy-to-use guides that provide a general discussion of the basic requirements for reporting, withholding, and depositing employment taxes, the distinction between independent contractors and employees, and the e-filing options for exempt organizations. Importantly, they also provide links to more detailed information and additional resources, as well as to all necessary forms.

EO advertised the availability of the employment tax web site to all members of the EO e-mail subscription list, EO Update, which currently has almost 12,000 subscribers, and placed an article about it in the Social Security Administration newsletter, the SSA Reporter, which reaches both employers and employees.

Government Entities

TE/GE's Government Entities (GE) function also conducts a strong customer education and outreach effort about employment taxes. In two of GE's three functional units—Federal, State and Local Government (FSLG), and Indian Tribal Governments (ITG)—a primary concern has been to improve compliance with employment tax law within the governmental and tribal communities. During the period FY 2001—2005, GE employment tax educational efforts included 4,069 events that

reached 150,969 participants. In addition to these face-to-face events, FSLG and ITG have established a substantial educational presence on the internet. This includes:

- Employment tax Frequently Asked Questions directed towards the unique needs of the governmental and tribal communities;
- Electronic publications, such as the *ITG Employment Tax Desk Guide and the FSLG Federal-State Reference Guide*;
- Electronic newsletters on current law changes impacting the communities; and
- “Ask-us” mailbox for general questions primarily relating to employment tax compliance.

B. Enforcement

The IRS’s enforcement program with respect to employment tax obligations of tax-exempt entities may be divided into two categories. The first is the Combined Annual Wage Reporting (CAWR) and other programs which SB/SE operates. The second is the examination program run by the EO function of TE/GE, including initiatives and special programs.

CAWR

The IRS and the Social Security Administration (SSA) jointly administer the CAWR program. The CAWR matches reported earnings and reported withholding of taxes. As noted, employers are responsible for withholding income, Social Security, and Medicare taxes from their employees’ wages. They must pay over the amounts withheld and file Form 94X series returns (Forms 940, 941, and 945) with the IRS.

The employer is also required to file Form W-2 Wage and Tax Statements for each employee, and Form W-3 (Transmittal of Income Tax Statements) with SSA. Correct Forms W-2 should include the same information summarized quarterly on the Forms 94X, while the Form W-3 summarizes the Forms W-2.

Ideally, all information reported on Forms 94X should match the information on Forms W-2 for a given year. The IRS, working with SSA, maintains three programs in this area. The first two, SSA CAWR and IRS CAWR, deal with instances where the Agencies have received all returns but there is a mismatch in the information reported. The third program deals with instances where the IRS does not have a Form 94X to match with the SSA data. In this testimony, we will refer to this third program as the CAWR Referral Program.

The SSA CAWR program resolves discrepancies between information (tax and credits) reported on Forms W-2 and W-3 information returns and data reported on the series 94X returns. Cases normally involve situations where the 94X reports higher wages than the Forms W-2 and W-3. The purpose of this program is to reconcile SSA accounts. SSA refers cases to the IRS where the employer fails to respond to two SSA inquiries. Under an agreement between the IRS and SSA, the IRS pursues all SSA CAWR cases. We may assess penalties where the discrepancy cannot be resolved.

Under this program, SB/SE pursues all of these SSA referrals without regard to what type of taxpayer is involved, whether it is a charity, government or a for-profit business.

Of the 157,355 SSA CAWR cases and closures in 2005, some 11,396 (7.2%), were TE/GE taxpayers. Of these, it appears that at least 7,700 were section 501(c)(3) organizations.

The second program is the IRS CAWR. This portion of CAWR resolves discrepancies between information (tax and credits) reported on the series 94X returns and the data reported on Forms W-2 and W-3 information returns. Where amounts reported on forms W-2 and W-3 are greater than those reported on Form 94X, IRS may assess additional tax and penalties where the discrepancy cannot be resolved.

Like the SSA CAWR, this work is done by tax examiners at several CAWR units at Service Centers, and is undertaken on behalf of the entire IRS. Unlike the SSA CAWR, IRS CAWR work is not mandatory, and therefore not all cases are pursued. Charities are selected and pursued using the same criteria as other IRS taxpayers. The criteria for selection are based generally on the amount of the assessments involved.

For 2005, of the universe of 659,717 IRS CAWR cases, 60,013 (9.1%) were TE/GE taxpayers. Of the 166,619 closures, 18,598 (11.2%) were TE/GE cases. Thus, approximately 25% of all IRS CAWR cases, and 31% of TE/GE IRS CAWR cases were pursued. Of the TE/GE closures, more than 12,400 were entities described in section 501(c)(3).

CAWR Referral Program—Potential Form 941 Non-filers.

The CAWR Referral Program concerns mismatches that occur when SSA has received Form W-3 & W-2 records from an employer, but the IRS has no record of a 941 being filed. These mismatches are posted to a database accessible by relevant operating divisions of the IRS, including TE/GE. The table below sets out the number of referrals. Unlike the SSA CAWR and IRS CAWR programs, SB/SE refers these cases to the other Operating Divisions for consideration.

CAWR Referral Activity

| Year | SB/SE | TE/GE | LMSB | Total |
|---------------------------------|--------|-------|-------|--------|
| FY03 (tax year 2001) | 64,226 | 4,367 | 3,558 | 72,151 |
| FY04 (tax year 2002) | 59,346 | 4,432 | 3,646 | 67,424 |
| FY05 (tax year 2003) | 51,735 | 3,935 | 2,183 | 57,853 |
| Projection FY06 (tax year 2004) | 53,647 | 3,950 | 3,113 | 60,710 |

TE/GE cases placed on the database include all TE/GE taxpayers: governments, tribes, exempt organizations, and pension plans. A review of the referrals indicates that by far the largest dollar amounts of these mismatches relate to governmental taxpayers and pension plans. The review also shows that well over half of the referrals are churches that appear to have no Form 941 reporting requirement.

The potential value of tax owed by all TE/GE entities on the CAWR database has declined dramatically. For 2001, the value of the tax owed cases was \$1.29 billion. This declined to \$1.16 billion for 2002, \$356 million for 2003, and \$180 million for 2004, the most current year. Of this \$180 million, the potential value of tax owed by 501(c)(3) organizations is \$17 million.

This large decline reflects in part, we believe, the significant attention that TE/GE, and in particular its Federal, State, and Local Governments unit (FSLG), has devoted to employment tax cases. FSLG uses the CAWR referral database, as well as other CAWR data, in its case selection work.

EO has not used the CAWR database. Instead, it pursued Form 941 non-filers through the use of Form 990 information returns. In 2002 and continuing until recently, EO used an automated system to select for examination organizations that reported salaries, wages, or executive compensation on the Form 990, but showed no filed Form 941 for the corresponding periods. EO conducted more than 800 examinations as part of this project. EO initiated the program because it believed that this set of circumstances was likely to identify high potential noncompliance. However, examination results did not support this hypothesis. We therefore discontinued the program and began work to find improved methods of case selection. As part of this effort, we will begin using CAWR referrals and other CAWR data as part of a broader case selection process through an automated system similar to that used by FSLG. EO also is working on an improved computer-based modeling system to help select productive employment tax examination cases. This new system, which uses all available data, including CAWR data and examination results, will be piloted this winter.

TE/GE—EO Examination Program

TE/GE's EO function contains an examination unit, EO Examinations. In five years, EO Examinations has grown from 432 FTE in 2001 to 472 FTE in 2005. The examination of exempt organization employment tax returns is integrated into EO's general examination program, and it is within this structure that most EO employment examinations are conducted.

In 2006, EO Examinations plans to close 6,100 returns of exempt organizations. In conducting these examinations, when the preliminary review indicates that further inquiry is appropriate, the agent obtains and conducts an examination of the exempt organization's employment tax returns. This has resulted in EO Examinations closing more than 1,200 employment tax returns of exempt organizations in each recent year.

The number of employment tax examination closures does not fully reflect the level of effort in the employment tax area because we evaluate whether to open an employment tax audit in most of our exempt organization examinations. However, unless a problem surfaces, time spent on this review is not reflected in our examination data systems because the agent does not open a formal employment tax exam-

ination. We have also created correspondence units whose work is accounted for separately.

In EO, we select employment tax cases in several ways. We selected most of our employment tax cases as part of an examination of other returns. Beyond that, we have a number of initiatives and special projects that address employment taxes. I will discuss each of these in turn.

Required Review of Exempt Organizations' Employment Tax Filings

Within EO, we examine exempt organizations' compliance with employment tax obligations as part of standard exempt organization audits. We do this by following our EO Examinations "Required Filing Checks"—that is, a guide to the elements we expect an agent to review in the course of an audit.

Exempt Organization examinations ordinarily include a "Required Filing Check" to determine if the organization is in compliance with *all* federal tax return filing requirements—including employment tax returns—and whether all returns report substantially correct tax. When warranted, we expand the examination to focus on specific returns.

Required Filing Checks address employment tax (including questionable Form W-4 procedures), excise tax, information returns, pension plan returns, and Forms 8300. The specific forms include:

- Form 940, Employers Annual Federal Unemployment (FUTA) Tax Return
- Form 942, Employer's Quarterly Federal Tax Return
- Form W-2, Wage and Tax Statement
- Form W-4, Employee's Withholding Allowance Certificate
- Form 1096, Annual Summary and Transmittal of U.S. Information Returns, including Form 1099 series
- Form 1120-POL, U.S. Income Tax Return for Certain Political Organizations
- Form 4720, Return of Certain Excise Taxes on Charities and other persons under Chapters 41 and 42 of the IRC
- Form 5500 series, Annual Return/report of Employee Benefit Plan

Form 8300, Reports of Cash Payments Over \$10,000 Received in a Trade or Business.

When EO decides to open an employment tax exam, as a result of the Required Filing Check process, we first insure that the tax has not already been paid, and that it has not been filed under an incorrect EIN number. When these preliminaries are completed, we open the case

Initiatives and Special Programs

Beyond its standard examination program, Exempt Organizations also conducts initiatives and special programs that focus on compliance with employment tax requirements by specific classes of exempt organizations. We have already discussed the EO Form 941 matching program. Another example of an employment tax initiative is the Medical Residents FICA program. The issue here is whether the medical residents are students employed by a school, college or university, and therefore exempt from FICA, or not. The IRS has taken the position that medical residents are subject to FICA, and that position has been strenuously challenged. We have won a case in a federal district court in the 11th Circuit, but lost two cases in the 8th Circuit on this question. The district court case in the 11th Circuit is now on appeal. We have a large number of claims pending in this area as well.

Another example of such an initiative involves the failure of some colleges and universities to comply with the withholding tax regulations on payments (such as wages, grants, scholarships and other income) to non-resident alien students, faculty and researchers. Under prior programs, we allowed taxpayers to voluntarily come in to us to resolve problems in this area. Subsequently, we decided to follow-up to see if compliance had improved after our educational and voluntary compliance programs. We conducted 12 examinations and 319 compliance checks. The change rate on the examinations was 92%. In the compliance checks program, delinquent returns were secured in 38% of the cases. After this program was completed, a research team took a second look to determine whether there was improvement in the filing of the required forms by the taxpayers involved. The team found a marked improvement. All but 8 of the colleges and universities were in compliance. More work in this area will occur in 2007.

A third initiative involves the use of one of EO's new enforcement units, the EO Compliance Unit (EOCU). This project focuses on exempt organizations that have filed a Form 941 showing a specific level of wages, but not a Form 990. In such cases, we would expect an organization that filed a 941 to also file a Form 990. The

EOCU is conducting compliance checks on a statistically-valid sample of 654 cases for tax years 2002 and 2003 to look into this situation.

III. Collection Practices

Another important part of the IRS's over-all employment tax enforcement strategy is the collection program for tax-exempt taxpayers. SB/SE conducts this program on behalf of TE/GE, as it does for the entire IRS. This section of the testimony describes the volume of TE/GE collection cases, the notice process and its effectiveness, and the manner in which cases are selected for individual collection actions.

The figures presented in this section include all TE/GE taxpayers. They include government agencies, Indian tribes, pension plans, and non-profits as well as charitable organizations. Our collection activity reports do not separate out these individual categories in greater detail.

It should be noted that in determining who to pursue in the collection process, SB/SE does not consider whether the taxpayer is a TE/GE taxpayer. Thus, TE/GE taxpayers, including charities, are treated in a manner similar to all other taxpayers.

To begin the Collection process, all entities showing a balance due are automatically contacted by notice sent from our Service Centers. In FY 2005 a total of 282,049 first notices were issued on balance-due accounts of TE/GE taxpayers. This amounts to about 2% of the more than 13,870,000 first notices issued to all types of taxpayers that year. About 53% of the TE/GE accounts are resolved by the taxpayer's self-correction before the fourth or final notice is issued.

A total of 131,669 TE/GE accounts required a fourth notice. (Of these 68,390, or about 52%, involved employment tax (trust fund) delinquencies.) About 49% of all fourth notices are resolved in that status.

Some 64,801 TE/GE accounts associated with 27,452 taxpayers continued into delinquent status for potential contact by telephone or by a revenue officer in the field. After application of certain screening criteria, 26,884 TE/GE accounts associated with 6,498 taxpayers met the criteria for assignment to the field for personal contact by a revenue officer.

At the end of FY 2005, 26,007 accounts, representing \$250 million in assessed balances due, were in the queue awaiting assignment. Of these 1,407 accounts—or 5%—represented nearly half of the total dollars due. The average balance due of the remaining 24,600 accounts was \$5,335.

As indicated, no distinction is made with respect to the type of taxpayer when prioritizing cases for assignment to employees in the call sites, or in the field for personal contact. As these employees are available for new work, cases are assigned according to a risk-based process. Although the process is complex, and there are some minor exceptions, generally the priorities are set with a focus on three factors:

- a. The type of tax being collected, which weighs more heavily toward employment taxes;
- b. The age of the delinquency; where the newest delinquency receives the higher priority; and
- c. The amount due; where the priority increases as more money is involved.

The absence of figures relating exclusively to exempt organizations' accounts makes difficult a precise evaluation of the IRS's collection program for exempt organizations employment tax. It is clear, however, that such cases are pursued, according to the same criteria that apply to other types of collection cases. Thus, the employment tax obligations of tax exempt organizations are pursued.

IV. Future Plans

Within the IRS, and within TE/GE, we have been hard at work on improving compliance with employment tax obligations across the board, and we have achieved some noteworthy successes, particularly with respect to potential tax due from Federal, state and local governments.

We continue to look for ways to improve charities' compliance with employment tax law, and to improve our collection of employment taxes owed but unpaid. We want, of course, to collect the tax, but we also hope that by developing better methods of detecting non-compliance in the employment tax area, we also will be able to detect non-compliance in other areas of the tax law related to charities.

With that in mind, we continue to develop new processes in the employment tax area.

Data Mining and Modeling Project

TE/GE currently has underway an initiative to develop a "risk model" that will detect, classify and quantify high risk compliance patterns. When completed in late September, EO Examinations will pilot the use of this risk model in selecting tax-

payers for examination. In developing the risk model, all available sources of data are being evaluated that could be helpful in identifying organizations likely to be non-compliant.

One aspect of the model focuses on identifying exempt organizations that are not fully meeting their employment tax obligations.

The primary source of the data to be used is our RICS classification system. RICS is a database and search engine that includes information for all exempt organizations that file, or are required to file, Forms 990 or 990 PF returns. RICS also includes information on related returns (including Forms 940 and 941) filed by these exempt organizations, and audit history information on taxpayers previously examined. One of the other data sources we are exploring for possible use in this project is the Combined Annual Wage Reporting (CAWR) system, discussed above. We hope this will allow us to be increasingly proactive in our selection of non-compliant charities, including those that are not meeting their employment tax obligations.

Expansion of Information Available for Case Classification

As mentioned, RICS is a TE/GE computer system that analyzes data about TE/GE taxpayers to help TE/GE classification staffs select the most appropriate TE/GE taxpayers for examination, or to identify appropriate remedies for specific taxpayer situations. RICS can effectively analyze multiple databases.

With this in mind, TE/GE is working to enlarge RICS' accuracy and usefulness by expanding RICS' access to relevant databases. Last year, RICS gained access to updated Business Masterfile (BMF) data, as well as to all CAWR data. TE/GE is now exploring best practices for querying and using this data to select productive cases for examination.

Access to these databases will also allow us to identify situations that require our attention but do not rise to the level of a full examination.

TE/GE classifiers are being trained and gaining experience with these new data sources, and this process will continue into the future. When fully familiar with the characteristics of the new BMF and CAWR databases, TE/GE classifiers will be able, among other things, to:

- Identify situations where no return has been filed but substantial tax deposits have been made (a situation amenable to resolution by "soft" contact rather than examination).
- Identify situations where a taxpayer thought to be delinquent has recently filed a return, and an examination would not be necessary.
- Identify situations where a taxpayer is working with Collections, and initiation of an examination would be inappropriate.

V. Conclusion

In sum, the IRS, using resources primarily from SB/SE and TE/GE, has a considered program for enforcing the employment tax law as it applies to charities.

While the law does not generally permit us to revoke a charity's tax-exempt status for its failure to comply fully with employment tax law, it does give us other tools to insist that charities meet their employment tax obligations, and we have active programs in place to do that. This said, we believe that as we improve selection techniques, we will be able to increase our coverage in this important area.

Chairman RAMSTAD. Thank you, Mr. Miller. Mr. Green, please.

STATEMENT OF JAMES S. GREEN, ASSOCIATE GENERAL COUNSEL, OFFICE OF THE GENERAL COUNSEL, U.S. OFFICE OF PERSONNEL MANAGEMENT

Mr. GREEN. Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to appear before you this morning to discuss the CFC, the annual workplace charity solicitation for Federal, civilian, military and postal employees. The CFC is actually 299 separate campaigns, each located in a geographic area with a substantial Federal population. The largest local campaign being the CFC of the National Capital Area. In 2005, Federal employees across the Nation and overseas donated over \$268.5 million to the CFC. Charities can apply to participate locally in the cam-

campaign where they provide their services or, for charities with a demonstrably more national or global program, apply to participate in all 299 CFCs as a national or international participant. Each charity wishing to participate in the CFC, whether as a local or national or international participant, must apply annually meeting eligibility and accountability requirements set out in OPM's CFC regulations. The applications of charities seeking local list eligibility are reviewed by that campaign's Local Federal Coordinating Committees (LFCC) made up of Federal employees who live and work in that geographic area and who volunteer their services to the LFCC. The LFCC acts as the campaign's board of directors, applying CFC eligibility and accountability standards. Charities seeking to participate as national or international charities apply directly to OPM's Office of CFC Operations. These national or international applicants also must meet established eligibility and accountability standards and must additionally demonstrate that they provide or conduct real services, benefits, assistance or program activities in 15 or more different states or a foreign country over the 3-year period immediately preceding the year in which they apply. A basic CFC eligibility criterion for all local, national or international charities is recognition by the IRS of tax-exempt status under section 501(c)(3) of the Internal Revenue Code and that contributions to that charity are tax deductible. The OPM has traditionally accepted a certification by the charities as to that tax-exempt status.

Given the review undertaken by the GAO that led to this proceeding, OPM is carefully reviewing how it can better assure itself and the Federal employees whose generosity has made the CFC a success that the 501(c)(3) status of participating charities is valid and current. Working with IRS, we are completing a review to confirm that all national and international charities participating in the fall of 2006 CFC have valid and current 501(c)(3) status. A similar review is currently underway in the National Capital Area's CFC, and we continue to analyze the best means to utilize that review process for charities participating in the other 298 local campaigns. The OPM will work directly with all of those 299 local campaigns on this process. We are confident that the review will be completed by the beginning of the 2006 CFC in September. We look forward to working with IRS, GAO and the Subcommittee to assure the continued integrity of the CFC.

That concludes my oral testimony. I will be pleased to respond to any questions Members of the Subcommittee might have for OPM. Thank you.

[The prepared statement of Mr. Green follows:]

Statement of James S. Green, Associate General Counsel, Compensation, Benefits, Products and Services Group, Office of Personnel Management

Background

Mr. Chairman and members of the Subcommittee, thank you for the opportunity to testify before you today on the Combined Federal Campaign (CFC) and the extent to which CFC participating charities comply with their Federal tax obligations to the Internal Revenue Service. The CFC is a fund-raising drive conducted every fall that allows Federal employees and military personnel to donate money to the charities of their choice through a workplace solicitation. Since its establishment in 1957 by Executive Order 10728 the campaign has raised over \$5 billion on behalf of charitable organizations across the country and around the world.

Management and Structure of the CFC

OPM is responsible for the overall management and oversight of the CFC. However, OPM does not directly manage the Federal employee contribution process. The CFC structure relies on the dedication and commitment of the Federal employees who make up the Local Federal Coordinating Committees (LFCC) to determine which organizations will administer local campaigns. Only charities seeking national or international status are vetted at the Office of Combined Federal Campaign Operations (OCFCO) at OPM headquarters. Through an annual competition, the LFCC's enter into agreements with a local non-profit organization, which we refer to as Principal Combined Fund Organizations (PCFO), to serve as the local fiscal agent, administering the local campaign by providing marketing, fund receipt and disbursement, accounting, and other administrative support. LFCC's also are responsible for reviewing and approving applications for participation by local charities in each of the 299 local CFC's. OPM's OCFCO serves a similar role in reviewing and approving the applications of national and international charitable organizations, which participate in all of the local CFCs. Thus, Federal employees in the geographic areas of the 299 local CFC's have a wide choice of donating to charities that provide local services, to charities that provide national and international service, or a combination of both.

OPM regulates and provides oversight and guidance to each of the local campaigns to ensure that each campaign is conducted in accordance with OPM regulations, congressional mandates, and established policy. This oversight is primarily conducted through the review of a number of accountability and status reports from each local campaign throughout the year. OPM also establishes the criteria for local and national/international participation. In the 2005 CFC, a total of 1,839 charities applied for national or international participation through OPM headquarters. Of these 1,714, or approximately 93%, were admitted. The estimated number of charities participating in all of the 299 local campaigns is over 20,000.

Although solicitation of Federal employees in the workplace is only permitted from September 1 through December 15 each year, each yearly CFC covers an approximate two-year period. The process begins with each LFCC's selection of a PCFO by March of the year, followed by the review of applications and completion of eligibility decisions around May of that year. Both local and national/international applicants have the right to have initial negative eligibility determinations appealed to OPM, with an ultimate eligibility determinations made by the Deputy Director of OPM. By regulation, OPM must complete its review of national applications and appeals by June 30 of each year. That timeframe allows sufficient time for the printing and distribution of the 299 local campaign brochures used as the primary vehicle to educate and solicit Federal employees as to which charities will be participating in their local CFC. The brochures list the local charities unique to each local campaign as well as the national/international organizations that participate in each CFC. The campaigns themselves take place during a 6 week period between September and December of each year. .

The majority of Federal employee contributions are made through payroll deduction and are processed by the local PCFO over the course of the 12 month period following the campaign which ran in the September through December timeframe. Actual distributions of the funds to the charities are made by each PCFO during that time as well. The campaign period ends with an audit of each PCFO's activities conducted by an independent public accountant but a local campaign is not considered closed until OPM is satisfied with the independent auditor's report and any findings are resolved.

Due to the decentralized structure of the CFC, a majority of the specific information related to the local campaigns and its participating charitable organizations is maintained locally. OPM has initiated projects to improve access to campaign information and to promote electronic giving. Specifically, OPM is currently developing a National Charity Registry that will collect important information on each charitable organization (international, national and local) that participates in the CFC. The design of this initiative began last year and is expected to be completed in time for the 2007 campaign. The first phase of the project is the assignment of new and unique codes for each of the estimated 20,000 participating charities. With the implementation of this centralized Registry of information, OPM will be in a better position to assess the status of all CFC participating charitable organizations.

Screening Charities for Participation in the CFC

All CFC participating charities must apply each year for that year's campaign, with an application made either to OPM or the appropriate LFCC, depending on whether the applicant is applying as a national /international or local organization. These applications set forth the information and background submissions required

by OPM's regulatory eligibility criteria and public accountability standards and each applicant must certify that information in order to participate in the CFC. These criteria were designed to ensure Federal donors that only legitimate, accountable, and responsible charitable organizations are admitted to the CFC. The criteria for both local and national/international applicants includes, but is not limited to, a demonstration by the applicant that it:

- Has status as an IRS determined tax-exempt charity under section 501(c)(3) of the Internal Revenue Code (what is the difference between this bullet and the next bullet?);
- Completed and provided to the IRS a Form 990, the annual tax return document for non-profits;
- Provides real health and human services, benefits, assistance or program activities; and
- Has an active and responsible Board of Directors, in which a majority of its Board members serve without compensation and without a conflict of interest.

Determinations of eligibility are based in part on a series of self certifications by the charitable organization, which affirms that the information provided is correct and that the charity agrees to comply with the eligibility criteria. For example, OPM requires that all applicants submit either to OPM or the local LFCC, depending on application status, a copy of its IRS 501 (c)(3) determination letter, a copy of its IRS Form 990, a copy of the organization's audited financial statement, a detailed description of its claim of providing real services, a copy of the annual report or more frequently published document such as a quarterly newsletter, information on its governing Board of Directors' compensation, meeting dates, and terms of office. In addition, in 2005 OPM amended the CFC regulations to add a new certification on compliance with terrorism prevention laws. OPM also is considering proposing revisions to its CFC regulations which we believe will streamline the CFC eligibility process and public accountability standards.

The current eligibility criteria do not require the applicant organization to disclose the status of its payment of payroll or any other taxes. A requirement for this type of information has not been included in the CFC Executive Orders or the existing congressional eligibility mandates. The current law prevents OPM from making the existing eligibility criteria more restrictive than it was under the eligibility criteria in effect in 1984. As such, OPM currently does not screen charities for compliance with tax payments to the IRS and has never denied an organization because of non-compliance in this area.

OPMs Oversight and Monitoring Program

In addition to the eligibility determination process for national/international applicants, OPM conducts a number of monitoring activities over local campaigns to minimize the risk of non-compliance with CFC regulations and prevent abuse in the CFC. In particular, OPM's OCFCO receives copies of audit reports for each local campaign as required by CFC regulations. OPM also receives audit reports from OPM's Office of the Inspector General, which audits approximately 15 local CFCs each year. The OCFCO reviews all audit findings and works with the local CFC's to resolve each finding. The OCFCO also selects a sample of local CFC brochures each year to review for compliance with CFC regulations and OPM guidance. In addition, the OCFCO requires each local campaign to report campaign results, including amounts raised, costs of the campaign, and Federal employee participation rates, after the solicitation period. This information helps us identify campaign performance and potential at-risk campaigns that might need assistance, require merging with another more efficient campaign, or require dissolution. Finally, OPM regularly communicates with the local campaigns to ensure that each campaign is operational and has an active LFCC.

Conclusion and Next Steps

In light of the GAO findings reported today, the Director of OPM has already requested that staff examine options for improving the screening process with particular emphasis on preventing charities that are not in compliance with Federal tax laws from participating in the CFC.

Mr. Chairman and Subcommittee members, this concludes my remarks. I am happy to answer any questions you or the members of the Subcommittee may have.

Chairman RAMSTAD. Thank you, Mr. Green. I want to thank all three witnesses for your testimony. I appreciate the tone as well as

the words of your testimony, the intent to get it right. Certainly we do not want to in any way damage the CFC. That is why we are here today.

The purpose of the CFC, or one of the purposes, is to give confidence to be donors that the charities are legitimate and they meet certain basic—certain minimal standards as a charity. Certainly, we would all have to recognize that the testimony of Mr. Kutz and the review by GAO raises some very troubling questions.

I guess the first question I have for you, Mr. Kutz, the most obvious question, what, if anything, does your review show that OPM did to approve charities, that is to prove participation in the CFC was actually a legitimate charity?

Mr. KUTZ. You are talking about with respect to our bogus charity?

Chairman RAMSTAD. Those three sting operations or bogus—

Mr. KUTZ. What we did is, again, we do these—we used only publicly available information, we used only off-the-shelf software, paper, whatever the case may be, to file something like this, and we pretty much followed the application process that any charity would follow in applying for the CFC. We put together the forms, including 990 information about our charity and the other documents that were required by OPM, and we filed three separate applications using the same charity for the campaign. As I mentioned, in May of 2006, several weeks ago, we received our letters authorizing us or approving our applications into the program. I believe what you are talking about is, I think it is a paper review to a large extent. They get the paper. They look at paper, and I think they approve the paper without any independent validation. The one thing that could be done is, as you mentioned, I believe, validation with the IRS that we indeed are a legitimate charity.

Chairman RAMSTAD. Is there a statutory barrier to that? Is that what I am hearing you say, Mr. Miller?

Mr. MILLER. There would be a statutory 6103 barrier to finding out if there is a tax delinquency with respect to a given taxpayer. We actually—in terms of whether an organization is exempt or not, we make that available in great detail both on our Web site and otherwise.

Chairman RAMSTAD. Mr. Green, the obvious question for you is, wasn't that data consulted, the data that Mr. Miller just said is readily available? It seems to me there should be an effort to validate whether an applicant is a legitimate charity.

Mr. GREEN. Mr. Chairman, we agree. Traditionally, the application process has in it information about 501(c)(3) status including a determination letter and a 990 as well as other information about the charity. There are some 20,000 charities that apply annually, and it is in fact a review with a dependence on the integrity of that application process. We are now using IRS databases, as I indicated in my earlier statement. We are confident that all of the charities will be checked before the 2006 campaign begins.

Chairman RAMSTAD. Then, it is a fair statement to say, prior to the GAO review, that database was not checked, and now as a result of the GAO review, it is being checked to corroborate that information.

Mr. GREEN. It is correct that it was not checked across the board. It has been checked where problems have been brought to our attention or a question has been raised. In this case, the information we got from the GAO was very legitimate looking and sounding applications, but we will be checking those now. In addition, Mr. Chairman, we are——

Chairman RAMSTAD. All of them?

Mr. GREEN. All of them. All of them locally, all the locals—the 299 locals as well the international and national. Mr. Chairman, we also are working on developing a registry which we believe will be in effect by next year's campaign, will have a one-place-to-go listing which will make that process easier, more reliable and more continual in campaigns in the future.

Chairman RAMSTAD. Well, I am encouraged to hear that OPM recognizes the problem, the obvious problem, and has taken corrective steps. That is the way government should work. That is the way we should work because the last thing we want to do is to damage the CFC and those charities that benefit those people in need, kids, senior citizens, the poorest of the poor, people suffering the ravages of disease and addiction and poverty. I am just grateful to hear that you are taking these corrective steps. I am grateful by the work that GAO did to facilitate this corroboration now, this improved checking, and I hope it continues.

Mr. Miller, beyond the statute you cited, were there any other barriers to corroborating the applications, the facts represented on applications by these charities?

Mr. MILLER. I am unaware of any barriers. There may be some. Obviously, if we did work out something with OPM to do a tax check on 20,000 organizations, that would be a substantial resource issue for us, and we would have to talk about that. We are going to talk to OPM to see what we can do to——

Chairman RAMSTAD. Just the fact of the 501(c)(3) certification, that speaks volumes from the IRS——

Mr. MILLER. That should be on the Web site. In fact, we can and will make our master file, which contains more data than is on the Web site, available to OPM.

Chairman RAMSTAD. Again, I thank all three witnesses. I now yield to my good friend, the ranking Member, Mr. Lewis.

Mr. LEWIS. Thank you very much, Mr. Chairman. Mr. Miller, do you have any idea of the number of organizations or groups that have lost their tax-exempt status in recent years for failing to comply with the tax laws?

Mr. MILLER. We have a process of revocation, as you are aware, Mr. Lewis. If the question is for failure to comply with employment tax laws?

Mr. LEWIS. Yes.

Mr. MILLER. In general, I do not think we have any instances that we were able to come up with. In preparing for this hearing, we did not find that. I would say more generally that failure to comply in and of itself with the employment tax rules is not likely to lead to a revocable sort of activity on behalf of the service against the organization. Not likely to revoke for that.

Mr. LEWIS. Would there be other factors that—other reasons that you would lift the tax-exempt status of a charitable organiza-

tion if it is, I think Mr. Kutz said, some of them are phony, that there may be—

Mr. MILLER. Absolutely, Mr. Lewis. There are a number of criteria for exemption, and often in some of these cases where you have someone putting the money in their pocket, that would be an independent sort of reason to say that that organization was no longer operating for charitable purposes, and that would cause a revocation. You might have employment tax problems that are incident to other underlying problems within the organization, and I am quite sure we have revoked—we do not revoke much. In 2005, we revoked perhaps as many as 30 charities, which actually is up a bit from past years. We do not do it often, but we have done it.

Mr. LEWIS. Do you tend to agree with Mr. Kutz? Do you see this as a serious problem?

Mr. MILLER. I see it as a problem. There is no question about that. We do what we can in the employment tax area. We do quite a bit, in fact. Many of the—many of the deficiencies are small, and in those cases, it is not likely that we are going to take much action because we do not have the resources to do that. I do think it is important and I would concur absolutely with my copanelists that we make sure that those in the CFC are shining examples of the charitable community because they are very much up front parts of the way the charitable sector is reflected. I would be concerned with too much of a failure to comply with CFC organizations because, again, they are examples to the Federal workforce and everywhere that could really taint the sector more generally. I do not have enough information to say that the employment tax issue is a real problem in the exempt sector. I don't know that it is. I can understand that problems with organizations in the CFC reflect badly on the sector generally, and that is a separate sort of problem.

Mr. LEWIS. When it comes to paying employment taxes, how would you compare it with businesses, the larger community? Do you look at that at all, Mr. Kutz?

Mr. KUTZ. Yes. In fact, we have looked at contractors, companies doing contracting with the government and their failure to pay payroll taxes.

Mr. LEWIS. Are people doing this, say, the big large Defense contractor—

Mr. KUTZ. It is not usually the big large ones. It is the mid-sized and small that have the payroll tax problems and those contractors owe \$5 to \$10 billion of Federal taxes, and they are getting billions of dollars of government business.

Mr. LEWIS. If you can speculate for a moment or two, why do you think people fail to do it? Is it a lack of bookkeeping, or do they just not want to pay their fair share?

Mr. KUTZ. Well, I think the corporations are different than the charities. The charities, I think they had serious cash flow problems. The most, I guess, egregious behavior is where the executives that made the decision not to pay the payroll taxes are drawing salaries greater than \$100,000; they effectively are choosing to pay themselves before paying the IRS, and I think that really is a fundamentally difficult issue to wrestle with.

I think your other point that you were trying to make, too, and I would say willful failure to remit payroll taxes is a felony. The question of revocation of charitable status or 501(c)(3) status for someone who may have committed a felony to me is a relevant question here that needs to be asked, and I don't really have the answer necessarily, but it is a policy question for this Subcommittee and your Committee to consider.

Mr. LEWIS. Thank you very much. Thank you, Mr. Chairman.

Chairman RAMSTAD. Thank you, Mr. Lewis. The gentleman from Arizona, Mr. Hayworth.

Mr. HAYWORTH. Thank you, Mr. Chairman. To our witnesses, thank you all for being here today highlighting a situation where we don't want to see the CFC somehow degenerate into a combined Federal con job. Sadly, as demonstrated by what we are hearing in your testimony, Mr. Kutz, in terms of fictional charities in the application, there is a lack of due diligence.

A couple of things have happened, and Mr. Green, perhaps you are in a position to answer this question best for me. I have to kind of come at it from another angle because there have been cases of charities held in pretty high regard that have been turned down for one reason or another by CFC. An Arizona-based charity, the Make-A-Wish Foundation, if I am not mistaken, was taken from that list and was more than a cause of casual concern for many of my constituents in Arizona.

Could you briefly outline the reasons why Make-A-Wish failed to make the grade?

Mr. GREEN. Certainly, Mr. Hayworth. Again, each year, charities have to apply to the CFC. The Make-A-Wish had been in the CFC for a number of years. One of the criteria that we use is the rate at which charities spend administrative—money on administrative funds rather than actually the programs they administer. As a mathematical formula, under our current regulations, if that annual fundraising rate exceeds 25 percent, then the charities have to explain to us why and demonstrate a plan to lower it. That is consistent—in the charitable community, that is fairly consistent with the standard. The Make-A-Wish Foundation for several years had been over the 25 percent limit. In last year's campaign, the administrative determination by OPM was that their plan to explain why and what they were doing to improve that after a couple of years of being at that level was insufficient. They were denied on that ground. They appealed through the internal administrative appeal process. The denial was affirmed. They then brought suit against the OPM in district court here in Washington, and that case was settled with the result that the Make-A-Wish Foundation was allowed to participate with a commitment to improve their fundraising rates.

Mr. HAYWORTH. Okay. A reputable charity based on a mathematical formula was barred. Everybody ended up in court, and they were reinstated. I do not believe there is any question I think the Make-A-Wish people would certainly welcome the scrutiny of what they do in terms of terminally ill children having an opportunity to realize their dreams in a very difficult situation. It points up both the true impulse of charity on the part of Federal employees and yet what seems to be on one hand stringent criteria but per-

haps mathematical formulas fitting in a certain way and a lack of due diligence on, “Hey, Let’s Invent a Charity, Inc.” and come to the Feds and find a way to become part of the CFC. I realize that in any situation there is going to be selective enforcement. I am glad to hear that Make-A-Wish was restored. I am sorry that it ended up being such a court case there.

Mr. Kutz, you found that there were more than 1,280 charities with unpaid tax debt participating in the CFC, and they owed about \$36 million in debt. You say that amount is understated. Can you explain why you think that is a low ball figure, or was that a deliberative understatement?

Mr. KUTZ. Yes. There would be quite a few reasons why. The first would be, it is only a portion of what actually the IRS knows. In other words, it represents only agreed to tax assessments, either agreed to by the taxpayer or affirmed by a tax court. We also excluded 2005 because a lot of things get resolved in the short term. It is truly delinquent. It is 2004 and earlier.

However, the bigger reason it is probably understated is it does not include the impact of non-filers or those who underreport, and as you probably on this Subcommittee would know, based on the tax gap, probably the unknown portion of the tax gap is greater than the known portion of the tax gap. I think the unknown portion here would likely or could be bigger than the known portion.

Mr. HAYWORTH. Mr. Miller, GAO makes it clear that its estimates of charities with unpaid employment taxes in the CFC are understated and there are likely more charities that are underreporting or not filing employment taxes. Do you agree with that assessment?

Mr. MILLER. If they took known assessments, then I would agree with that, that there would be more dollars out there in all likelihood.

Mr. HAYWORTH. One final question, Mr. Green, just to satisfy curiosity. Often there is an equation, deliberate or not, in the popular mind some people deem CFC kind of like United Way with the Federal Government, the notion of unified charities, combined giving. Sadly, some local United Way chapters have chosen to restrict the Boy Scouts of America from funding. Have there been examples on the 299—has there been a situation where the Boy Scouts of America has been barred in any way from the CFC?

Mr. GREEN. Mr. Hayworth, the eligibility process is uniform across all 299—the standards are uniform across all 299 local campaigns. I do not know if that has happened in any local campaign, but the local campaigns, if a charity is denied at the local level, they do appeal. Ultimately that appeal does come to OPM headquarters and would be reviewed by ultimately the deputy director of OPM. If there was a local that denied the Boy Scouts and the Boy Scouts felt that they were improperly denied, they would have that appeal process. I do not know off the top of my head whether that has happened, that that would come—

Mr. HAYWORTH. If you could check and get back to me with some correspondence, Mr. Green, I would appreciate it.

Mr. GREEN. I would be happy to do that, Mr. Hayworth.

Mr. HAYWORTH. Thank you, Mr. Chairman. Thank you for your indulgence on the clock there.

Chairman RAMSTAD. Thank you, Mr. Hayworth.

The gentleman from North Dakota, Mr. Pomeroy.

Mr. POMEROY. Mr. Chairman, before I begin on the topic of today's hearing, I want to express some concern about the Subcommittee itself, and I do so with the highest respect for you, and I believe and I want to make this very clear. I believe that under our present Committee structure, Subcommittee Chairmen are allowed to do what the Chairman of the full Committee allows them to do. That said, this is the 17th month of the 109th Congress. This is the eighth hearing of this Subcommittee. Today's hearing: Are charities in the CFC meeting their employment tax responsibilities? This is a very focused inquiry precisely within the jurisdiction of this Subcommittee. I am happy to follow issues like this, and I hope that we will have the positive benefit of OPM's being a little more aggressive in terms of making certain that we have got only appropriate entities participating in the CFC.

Yet there are so many other things that I wonder about relative to the IRS, the administration of the Tax Code, that are within the purview of this Committee. We have an estimated tax gap of \$312 to \$352 billion a year. We are running a deficit at about that amount. If we could get all the taxes collected that are owed, maybe we wouldn't have a deficit. Certainly we wouldn't have a deficit of this dimension. How can we improve our tax collection efforts? Where are the shortfalls for the tax gap? Man, that would be an interesting hearing. I would like to go to that one.

Tax shelters, we have made progress on some. We know there are billions of dollars of abuse continuing. Often a little daylight is, as the old saying goes, the best disinfectant and more focus on tax shelters may prevent some of the accumulating abuses that we have seen in the past. We have, to my view, an overall lack of audit of high income, corporate taxpayers. Maybe this is true; maybe it is not. There are some of us who think, those of us—they, those on the higher end, high corporate taxpayers, high-income corporate taxpayers are not paying what they owe. Let us talk about that. If that is an erroneous perception, I would sure like to hear from the IRS about the full gamut of activity they are doing there.

Finally, administration of our pension laws. We are in a pension conference. The most important pension revisions considered. The Pension Benefit Guaranty Corporation is 7 months late in publishing its last fiscal year report. What is that about? I would be very interested in seeing what this Committee could do to fully develop the information that our conferees might find helpful relative to pension.

I really am disappointed that the Chairman of the Committee on Ways and Means clips our wings so severely that today we are looking at, are charities in the CFC meeting their employment tax responsibilities? I think we have got more to do than that. I would hope in the months remaining in this 109th, the Chairman may allow us to get after the work that the Subcommittee is charged to do. Again, when I say Chairman, I don't mean you, Mr. Subcommittee Chairman. I mean the full Committee Chairman.

Let us talk a bit about this tax-exempt organization policing function within the IRS. Mr. Miller, that is your division?

Mr. MILLER. Yes, sir.

Mr. POMEROY. It is my understanding that the number of tax-exempt organizations have increased 55 percent since 1995. Is that correct?

Mr. MILLER. I do not know the percentage, but they do go up probably by 70,000 a year, and they are up into the 1.8—1.8 million range.

Mr. POMEROY. One point eight million entities.

Mr. MILLER. Yes.

Mr. POMEROY. How about the staffing and resources committed to the Tax-Exempt Organization Department, the department you run to look after all of this?

Mr. MILLER. We actually have gone up somewhat in the last couple of years through the work of Congress and Commissioner Everson.

Mr. POMEROY. I am pleased about that. In any way commensurate with the additional numbers of—

Mr. MILLER. I do not think we have doubled in size, no, sir. We have gone up perhaps 20 percent.

Mr. POMEROY. A 20-percent increase in the last 2 years?

Mr. MILLER. In the last 3 years, let us say.

Mr. POMEROY. Do you have enough to do your job?

Mr. MILLER. I think that we continue to push for more resources. We could always use more resources, but we have grown nicely in the last couple of years, and we need a little bit of time, frankly, to incorporate that—

Mr. POMEROY. I completely understand that. My question is, do you have the resources required to do the job you are assigned to do?

Mr. MILLER. Yes, we believe we do. We would like to—we would like the President's budget to be passed, and that would give us more resources, obviously.

Mr. POMEROY. I thank the gentleman. I yield back.

Chairman RAMSTAD. Since the chair was mentioned in your critique, Mr. Pomeroy, I just would respond. You say, and I believe I am quoting, we should do the work that the Subcommittee is charged to do. Well, certainly the Oversight Subcommittee of Ways and Means is responsible for conducting oversight of tax-exempt entities. We have been holding hearings on tax-exempt entities for more than a year. I guess I am surprised to hear you at-least implicitly say that when three fake charities apply to the CFC and are given legitimacy, it is not a problem. I think it is a problem. It goes to the very heart of the CFC, and we don't want to see damage done to the CFC. Our role is to provide oversight.

I also think it is surprising that the 1,280 charities with unpaid tax debt participating in the CFC seems to be minimalized. They owe \$36 million in debt, and that is real money, at least where I come from. I think there are problems that are worthy and I am not—I also, by the way, agree with you. Let us hold a hearing on the tax gap. I think that is a worthy subject matter of a future oversight hearing. I certainly would welcome any discussions, public or private, as to your ideas for future hearings. I appreciate your concern. You are a good friend and a good Member of this Subcommittee, a valued Member of the Subcommittee, but I think to charge that today's hearing is not appropriate or shouldn't be

held, that it is a problem of a minimal nature, I think is off target. With that, I look forward to talking with you, Mr. Pomeroy, about your future ideas for hearings, and we will continue to work together accordingly.

Do any of the other panelists, any other Committee Members rather, have further questions?

Mr. POMEROY. Not to prolong the dialog, Mr. Chairman, but if I just might put into perspective what I intended to say. Maybe I didn't get it said right. I am happy to participate in this hearing, interested in the inquiry, hope that we have made some progress by shining some light here this morning on having OPM exercise greater diligence for their role in this. The IRS, too, if it comes to that. This is all well and good. It is a fine function. I am happy to spend Subcommittee time on this topic.

There are so many other things, and I am frustrated that we have not had the license of the full Committee Chairman to, in my opinion, more aggressively explore this Subcommittee's jurisdiction on some of these issues, and I am so pleased that you did indicate the tax gap might be an area we could inquire into, and I look forward to participating in that hearing. Thank you.

Chairman RAMSTAD. Well, again, I would just suggest to my friend from North Dakota that he give me—or the ranking Member or any of the Members on either side—a suggested list of subjects to be examined by this Committee. Certainly, the Subcommittee Chair is open to that, and I will take it to the full Committee Chair, and so far, I haven't been denied any requests by the full Committee Chair.

I just want to ask you, Mr. Kutz, a final line of questions. In your written testimony, you indicated that more than 170 CFC charities with tax debt also received \$1.6 billion in Federal grants. How is this possible?

Mr. KUTZ. There is nothing that precludes, in our understanding, by law them from getting those grants. When they actually apply using, I guess it is called the OMB form 24, they have to certify whether they have any Federal tax debt, which would include tax debts, student loans, whatever the case may be. We did not investigate that form, but we understand that they certify. Obviously, there is nothing preventing them from getting those grants similar to there is nothing to prevent contractors from getting government contracts that have serious tax problems. It is the—

Chairman RAMSTAD. Doesn't the application for Federal grants specifically ask the applicant if they are delinquent on any Federal liability?

Mr. KUTZ. It does. It has a yes/no. If it is a "yes," you have to explain what the debt is that you owe.

Chairman RAMSTAD. Is it your presumption that these were fraudulently filed applications?

Mr. KUTZ. They either lied or the people who reviewed the forms disregarded the answer or didn't follow up on it would be my assumption, but we did not look at those forms specifically.

Chairman RAMSTAD. Was there any one particular agency that awarded the majority of the grants to the tax deadbeat charities?

Mr. KUTZ. Yes. I have the notes of who the entities are. You have got—Health and Human Services was \$811 million of the

amount. Education was \$530 million. The USAID was \$169 million. Commerce was \$15 million. Energy, \$13 million. Labor, \$9 million. NASA, \$7 million. Then a bunch of other ones were the rest. Keep in mind, our analysis excluded things like Medicaid. It was only limited to certain grant systems, and we looked at the payment systems that were—these were payments made, so \$1.6 billion of payments made related to grant programs at those specific agencies.

Chairman RAMSTAD. Thank you, Mr. Kutz. Mr. Miller, the statements you just heard obviously beg the question, the IRS has regulatory authority over charities and other tax-exempt organizations. Obviously, it can revoke the tax-exempt status of an organization for a number of reasons. If a charity was to repeatedly fail to pay its employment taxes, would this result in the revocation of its exempt status?

Mr. MILLER. Well, it is going to depend on the fact—I hate to use the facts and circumstances answer, but it really will depend if they are small amounts, if there is no attribution to the board of directors. In most instances, that is not going to be—create a revocable sort of activity on the part of the organization. Really the issue is not whether you were violating employment tax law, but are you violating law? Are you acting in other than a charitable fashion? In and of itself, not paying your employment tax as any citizen should is not going to be a cause for revocation of status.

Chairman RAMSTAD. Should it be?

Mr. MILLER. That really is a policy issue that, you know, I am not really prepared to answer, to be honest with you.

Chairman RAMSTAD. Any other comments?

Mr. KUTZ. I would just say this with respect to, again, the felony aspect of this with payroll taxes, willful failure to remit payroll taxes is a felony under current law and—

Chairman RAMSTAD. Failure to remit.

Mr. KUTZ. Failure to remit, yes. We did interview several of these charity executives with our Federal agents, and several of them willingly admitted that they did divert the money willfully, and part of the money went to pay their salaries. Effectively, they admitted to us that they had committed a felony. To me, that would be a serious matter. Again, I do not know whether that would be a revocable matter with what Mr. Miller said, but certainly I think it is something that needs to be on the table.

Chairman RAMSTAD. I think there have been a lot of serious matters revealed today and certainly by your study that need to be on the table. Mr. Miller, let me ask you this: Has your division ever made a criminal referral of one of these cases, ever?

Mr. MILLER. We—in preparing for the hearing, we did find, I believe, that we made one referral to our criminal investigation folks. I believe that was last year.

Chairman RAMSTAD. Are there any follow-up questions? The gentleman from North Dakota.

Mr. POMEROY. Mr. Chairman, a question for Mr. Kutz. Has GAO done studies as to the tax liabilities of for-profit entities that are participating with the Government in a contract relationship?

Mr. KUTZ. Yes. We have done that for Mr. Ramstad's colleague over on the Senate, Senator Norm Coleman. I have testified several

times over there on Defense contractors, civilian agency contractors and also contractors that are on the GSA schedule. In all cases, we found billions of dollars of unpaid taxes and I would say even more egregious behavior by the owners of some of these, as I mentioned to Congressman Lewis, more small to mid-sized companies, but these people were clearly in some cases lining their pockets with payroll tax money, making loans to themselves, and there was much more egregious behavior there than on the parts of the charity executives we saw here, although either way if you look at the law, it is still a felony.

Mr. POMEROY. Yes. I think it is very troubling that we would have this in the nonprofit, but so we understand the full picture, we also have trouble with our own government contractors. Now, is there routinely an application where they are disqualified from further contracts with the Federal Government when they are not paying the taxes at all?

Mr. KUTZ. Absolutely not. None of these had been barred from doing business, and none of them were pursued criminally by the IRS until we referred them. We referred all 120 of the most egregious cases that we investigated to the IRS. Again, whether there will be any indictments and prosecutions of those has yet to be determined. We have been doing that work for the last several years.

These contractors, just to get to the numbers you are talking about, they owe probably anywhere from \$7 to \$10 billion. There is some fairly significant money associated with government contractors that have tax problems and a lot of it is payroll taxes.

Mr. POMEROY. Even though you have turned this information over to the IRS, you are not aware of a single entity of those who owe the \$7 to \$10 billion having lost their ability to enter further contracts with the government.

Mr. KUTZ. Not as a result of our findings, no. They may have been doing other things that were revoked. There may have been product substitution cases or other things like that, but not as a result of the tax issues that we looked at. I would say that holds true—you know, we have 15 cases we investigate—

Mr. POMEROY. Do you know, for example, with Defense contractors, does the Pentagon have this information? Are they—do they make decisions on future contracts? Irrespective of what the IRS is doing, if these people are cheating on their tax obligations and it is called to the Pentagon's attention, do they still contract with them some more?

Mr. KUTZ. Well, that gets into the 6103, sharing of information, and we can certainly have back and forth information with the IRS, but we were unable to refer any of our cases to the Defense Department or Homeland Security or anyone else who has contractors that have these problems. That would be an issue for this Subcommittee to consider, for certain purposes, sharing of that information because that does create an impediment to enforcement of the Tax Code, and it clearly creates an impediment for law enforcement to go after these people from a criminal perspective.

Mr. POMEROY. I thank you. I thank the Chair.

Mr. KUTZ. I would just add, too, on the—we did do 15 cases for this work today and none of those 15 were being pursued criminally by IRS, although they were all being pursued from a collec-

tion standpoint, and I believe one of the 15 executives had been assessed a trust fund penalty personally for the charity payroll tax debt.

Chairman RAMSTAD. Does the gentleman yield back?

Mr. POMEROY. I yield back.

Chairman RAMSTAD. Mr. Miller, I just want to ask you a summary question really, and we are about ready to wrap up this Subcommittee hearing. Let us say a charity withholds a million dollars from its employees' paychecks, and that charity fails to remit the money to the Government, uses the money, as you have explained, Mr. Kutz, in some instances to pay the salaries of the charity's executives; do you think that charity should maintain its tax-exempt status?

Mr. MILLER. Well, I am going to have a tough time answering a hypothetical. I would say, it really is going to depend on, as I say, what are the facts around it? I think we have the—we at the service have the tools short of revocation including, quite frankly, an election process, closing down the organization, short of revocation in many of these instances. It would be—is this million dollars being funneled to the pockets—outside of compensation, is it being used for charitable purposes? Do the people know what they are doing? All these things. Is there attribution to the organization by the people who are failing to withhold? There are all these sorts of things that we would look at. I couldn't give you a solid answer. I would say that we would at a minimum pursue the tools we have.

Chairman RAMSTAD. I guess my question is, really, under current law, you could revoke the tax-exempt status for such conduct; is that not correct?

Mr. MILLER. Absent more than what you have presented, perhaps not. Again, it needs to rise to a purpose of the organization to avoid the tax law. It has to have a substantial nonexempt purpose of the organization. It is not just violation of the employment tax rules.

Chairman RAMSTAD. Perhaps we need to look at the law and at changing the law. Mr. Kutz?

Mr. KUTZ. I think that is a valid policy consideration for this Subcommittee and the full Committee, yes.

Chairman RAMSTAD. Mr. Green, do you have any comment?

Mr. GREEN. If the IRS was to withdraw 501(c)(3) status, that would be a disqualifying factor either before application or during the campaign, and that charity would no longer be permitted to participate, but we would look to the IRS to initially make that determination.

Chairman RAMSTAD. Yes. You are alluding to the distinction Mr. Miller made, which I guess I didn't quite clearly understand, the difference between removing or disqualifying an organization, a charity, taking away its tax-exempt status from shutting it down. Well, aren't the two equivalent?

Mr. MILLER. Well, they are really not. I think the—

Chairman RAMSTAD. In other words, a charity can go out and solicit funds when its 501(c)(3) status has been revoked?

Mr. MILLER. No. It could solicit funds, though, when padlocks were on the door because we have tax liens against the organization.

Chairman RAMSTAD. I see the point you are making.

Well, if there are no further questions from any Members of the Subcommittee, again, I want to thank all three of you gentlemen for participating today. I think I am encouraged by the spirit of collaboration that I heard from the panelists, and again, Mr. Kutz, I want to commend you and those at GAO who worked on the review for bringing out some of these troubling but important revelations. The hearing is adjourned.

[Whereupon, at 12:03 p.m., the Subcommittee was adjourned.]

