



*Screening Tax-Exempt Organizations' Filing
Information Provides Minimal Assurance
That Potential Terrorist-Related Activities
Are Identified*

May 21, 2007

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This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 21, 2007

MEMORANDUM FOR COMMISSIONER, TAX EXEMPT AND GOVERNMENT ENTITIES
DIVISION

Michael R. Phillips

FROM:

Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – Screening Tax-Exempt Organizations’ Filing
Information Provides Minimal Assurance That Potential
Terrorist-Related Activities Are Identified (Audit # 200610044)

This report presents the results of our review to assess the Exempt Organizations (EO) function’s efforts to identify and work cases involving tax-exempt organizations and/or related individuals potentially involved in terrorist-related activities. A significant source of alleged terrorist support has been the use of charities and nonprofit organizations to raise money, move persons and materials, and provide logistical support for the international operations. The possibility that terrorist attacks could be facilitated by charitable organizations exempt from paying taxes threatens to erode public confidence in both the integrity of the charitable community and the ability of the Internal Revenue Service (IRS) to regulate this community. This audit was conducted as part of the Treasury Inspector General for Tax Administration’s Fiscal Year 2006 Annual Audit Plan.

Impact on the Taxpayer

The IRS¹ uses a manual process and a limited terrorist watch list to identify instances in which charitable and other nonprofit organizations may be linked to individuals and/or entities whose assets have been frozen because they have committed or pose a significant risk of committing acts of terrorism. As a result, the IRS provides only minimal assurance that tax-exempt organizations potentially involved in terrorist activities are being identified. If the IRS does not use all available information to detect possible links of charities and nonprofit

¹ References in this report to the IRS relate specifically to the IRS functions primarily responsible for screening tax-exempt organizations’ filing information for terrorist-related activities. Applications for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code (Form 1023) are reviewed by EO function personnel in Cincinnati, Ohio. Returns of Organization Exempt From Income Tax (Form 990) are reviewed by Wage and Investment Division personnel in Ogden, Utah.



*Screening Tax-Exempt Organizations' Filing Information
Provides Minimal Assurance That Potential Terrorist-Related
Activities Are Identified*

organizations to known or suspected terrorist organizations or individuals, there is a risk that these charities will not be reported to the Federal Government authorities fighting terrorism.

Synopsis

The EO function could significantly increase its effectiveness in identifying potential terrorist financing and safeguarding the charitable sector from terrorist abuse by developing and enhancing automated systems to compare the large amount of tax-exempt information processed annually against a list of known or suspected terrorist-related organizations. Currently, IRS personnel review two key filings² by tax-exempt organizations to identify potential links to terrorist activities. In October 2002, IRS personnel started manually comparing names/organizations on these Forms against a terrorist watch list maintained by the United States Department of the Treasury Office of Foreign Assets Control (OFAC).³ At the time of our review, the OFAC terrorist watch list contained approximately 1,600 unique terrorist/organization names or aliases.

This manual process has identified only a small number of potential terrorist-related cases. The development of a process that will enable the IRS to systemically match Returns of Organization Exempt From Income Tax (Form 990) information, as well as consideration of matching Applications for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code (Form 1023) data when available in usable format, will significantly increase the probability of identifying potential terrorist activities related to tax-exempt organizations, allow for more effective use of IRS resources, and help preserve the public's trust in the charitable sector.

On September 16, 2003, Homeland Security Presidential Directive-6 was signed, directing that a center be established to consolidate the Federal Government's approach to terrorism screening and to provide for the appropriate and lawful use of terrorist information in screening processes. As a result, the Attorney General, the Director of the Central Intelligence Agency, and the Secretaries of the Departments of State and Homeland Security signed a Memorandum of Understanding creating the Terrorist Screening Center (TSC) and placed it within the Federal Bureau of Investigation, United States Department of Justice. The TSC began operations on December 1, 2003, and is charged with consolidating and maintaining the United States

² The two forms are Form 1023 and the Form 990 series, including Form 990, Short Form Return of Organization Exempt From Income Tax (Form 990-EZ), and Return of Private Foundation (Form 990-PF).

³ The OFAC terrorist watch list is maintained by the United States Department of the Treasury and contains names of organizations, countries, and some individuals whose assets have been frozen because they have committed or pose a significant risk of committing acts of terrorism.



*Screening Tax-Exempt Organizations' Filing Information
Provides Minimal Assurance That Potential Terrorist-Related
Activities Are Identified*

Government's terrorist watch list.⁴ The Secretaries of the Departments of Defense and the Treasury signed an addendum to the Memorandum to join the partnership supporting the TSC in August 2004. The TSC terrorist watch list currently contains more than 200,000 names suspected of being involved in terrorist activities.

EO function management officials believe the OFAC is well positioned to identify suspicious persons who might take advantage of the financial markets to raise or divert funds for terrorist purposes or to undermine the financial system for such purposes. Department of the Treasury officials advised us that the EO function is not required to use the TSC terrorist watch list when reviewing filing data of tax-exempt organizations. However, the TSC terrorist watch list and other available terrorist watch lists contain more comprehensive lists of potential terrorists and may be beneficial for the IRS to use, in conjunction with the OFAC terrorist watch list, in its screening of tax-exempt organizational data.

In addition, since 2004, Tax Exempt and Government Entities Division management has been working with the Criminal Investigation function to test the systemic matching of Forms 990 Schedule of Contributors (Schedule B) data for possible terrorist connections. This will be accomplished by comparing filing data against databases of multiple terrorist watch lists, including the OFAC terrorist watch list. This project is currently in the testing mode, and the implementation date is unknown.

Recommendations

We recommended the Director, EO, in coordination with key IRS and external stakeholders, develop and implement a long-term strategy to automate the process used to initially identify potential terrorist activities related to tax-exempt organizations. In addition, the Director, EO, should evaluate whether more comprehensive terrorist watch lists, including any applicable TSC information, should be used in conjunction with the Department of the Treasury OFAC list during the IRS screening processes, to improve the identification of individuals and/or organizations potentially involved in terrorist-related activities.

Response

EO function management agreed with our recommendations and plans to develop a long-term strategy to automate the checking of names on Forms 1023 and 990 against a terrorist watch list. EO function management is currently testing and evaluating software that will check names on

⁴ The TSC was assigned responsibility for consolidating terrorist screening information to be used by Federal, State, local, territorial, tribal, and foreign governments and private sector organizations across the country and around the world. The TSC terrorist watch list is a consolidated database that contains all information permitted by law on the identities of individuals known or appropriately suspected to be involved in terrorist activities obtained from these entities.



*Screening Tax-Exempt Organizations' Filing Information
Provides Minimal Assurance That Potential Terrorist-Related
Activities Are Identified*

Forms 990; they will develop similar plans for checking names on Forms 1023. In addition, EO function management agreed to meet with Federal Bureau of Investigation personnel to evaluate how the TSC information may serve their needs and will evaluate whether other, more comprehensive terrorist watch lists can be used. Management's complete response to the draft report is included as Appendix IV.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Nancy A. Nakamura, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.



*Screening Tax-Exempt Organizations' Filing Information
Provides Minimal Assurance That Potential Terrorist-Related
Activities Are Identified*

Table of Contents

Background	Page 1
Results of Review	Page 3
The Current Screening of Tax-Exempt Documents for Potential Terrorist Activities Is Inefficient and Incomplete.....	Page 3
<u>Recommendations 1 and 2:</u>	Page 8
Appendices	
Appendix I – Detailed Objective, Scope, and Methodology	Page 9
Appendix II – Major Contributors to This Report.....	Page 11
Appendix III – Report Distribution List	Page 12
Appendix IV – Management’s Response to the Draft Report	Page 13



*Screening Tax-Exempt Organizations' Filing Information
Provides Minimal Assurance That Potential Terrorist-Related
Activities Are Identified*

Abbreviations

EO	Exempt Organizations
HSPD	Homeland Security Presidential Directive
IRS	Internal Revenue Service
OFAC	Office of Foreign Assets Control
TSC	Terrorist Screening Center



*Screening Tax-Exempt Organizations' Filing Information
Provides Minimal Assurance That Potential Terrorist-Related
Activities Are Identified*

Background

Uncovering the root of terrorist financing has become one of the biggest challenges facing the United States in the aftermath of the September 11, 2001, terrorist attacks. One significant source of alleged terrorist support has been the use of charities and nonprofit organizations to raise money, move persons and materials, and provide logistical support for the international operations. Beyond the horrors caused by terrorist acts, the possibility that the attacks could have been facilitated by charitable organizations exempt from paying taxes threatens to erode public confidence in both the integrity of the charitable community and the ability of the Internal Revenue Service (IRS) to regulate this community.

The use of charities and nonprofit organizations is a significant source of alleged terrorist activities and threatens to erode public confidence in the integrity of the charitable community.

In Fiscal Year 2006, there were about 1.6 million tax-exempt organizations (excluding churches) with \$2.4 trillion in assets and \$1.2 trillion in annual revenues, and the numbers are growing. In recent years, there has been significant growth in the number of entities recognized as exempt, with more than 80,000 determination applications¹ closed annually. In addition, the latest available IRS statistics show that, for Tax Year 2003, charitable tax-exempt organizations filed approximately 300,000 information returns² that were subject to review for possible terrorist connections. Public concern about the oversight of charities and terrorist financing has resulted in increased attention from the media and oversight bodies. *The New York Times* recently noted, "In the last decade . . . the number of charities and their assets exploded and State and Federal money spent monitoring them remained flat or declined." Furthermore, the Senate Finance Committee is investigating whether any exempt organizations are linked to terrorism and, if so, how the IRS and others are handling the problem.

As the Federal Government agency responsible for tax administration, the IRS role is to assure that Federal tax laws are not violated, including determining whether tax-exempt charities are potentially being used to divert charitable funds to support terrorist activities. The Exempt Organizations (EO) function of the Tax Exempt and Government Entities Division has primary responsibility to ensure tax-exempt status is not granted to organizations used to support terrorist

¹ To be exempt as a charitable nonprofit entity, an organization must file an application for recognition of exemption with the IRS (Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code (Form 1023)).

² This includes Return of Organization Exempt From Income Tax (Form 990), Short Form Return of Organization Exempt From Income Tax (Form 990-EZ), and Return of Private Foundation (Form 990-PF).



*Screening Tax-Exempt Organizations' Filing Information
Provides Minimal Assurance That Potential Terrorist-Related
Activities Are Identified*

activities. In addition, the EO function analyzes annual information returns filed by tax-exempt organizations to identify any organizations potentially involved in terrorist-related activities.

A key tool in the fight against terrorism is the various terrorist watch lists that contain consolidated information on the names and other identifying information for all known or suspected terrorists. Traditionally, Federal Government agencies have used various means, developed in response to their individual missions, to manage terrorist watch list information. The attacks of September 11, 2001, underscored the need for standardization and consolidation of the terrorist watch lists to help ensure homeland security.

On September 16, 2003, Homeland Security Presidential Directive-6 (HSPD-6) was signed, directing that a center be established to consolidate the Federal Government's approach to terrorism screening and to provide for the appropriate and lawful use of terrorist information in screening processes. As a result, the Attorney General, the Director of the Central Intelligence Agency, and the Secretaries of the Departments of State and Homeland Security signed a Memorandum of Understanding creating the Terrorist Screening Center (TSC) and placed it within the Federal Bureau of Investigation, United States Department of Justice. The TSC began operations on December 1, 2003, and is charged with consolidating and maintaining the United States Government's terrorist watch list.³ The Secretaries of the Departments of Defense and the Treasury signed an addendum to the Memorandum to join the partnership supporting the TSC in August 2004.

As of December 31, 2005, the Department of the Treasury had applied economic sanctions that have blocked almost \$14 million belonging to several international terrorist organizations or other related designated parties.⁴ In addition, \$368.9 million in assets of designated State sponsors of terrorism have been blocked pursuant to economic sanctions imposed by the United States.

This review was performed at the Tax Exempt and Government Entities Division Headquarters in Washington, D.C.; the EO Determinations office in Cincinnati, Ohio; the EO Examinations office in Dallas, Texas; and the Submission Processing unit of the Ogden, Utah, Submission Processing Site during the period August through December 2006. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

³ The TSC was assigned responsibility for consolidating terrorist screening information to be used by Federal, State, local, territorial, tribal, and foreign governments and private sector organizations across the country and around the world. The TSC terrorist watch list is a consolidated database that contains all information permitted by law on the identities of individuals known or appropriately suspected to be involved in terrorist activities obtained from these entities.

⁴ This figure does not include amounts reported to the Department of the Treasury Office of Foreign Assets Control as blocked and for which the appropriateness of the blocking is under review. We could not determine if any of these organizations were tax-exempt organizations.



*Screening Tax-Exempt Organizations' Filing Information
Provides Minimal Assurance That Potential Terrorist-Related
Activities Are Identified*

Results of Review

The Current Screening of Tax-Exempt Documents for Potential Terrorist Activities Is Inefficient and Incomplete

The IRS⁵ does not systemically match filing data of tax-exempt organizations against a comprehensive list of potential terrorists to identify instances in which charitable and other nonprofit organizations may be linked to terrorist activities. Instead, IRS personnel manually review all tax-exempt documents and compare information from them to a United States Department of the Treasury terrorist watch list. This list, however, is incomplete compared to the more comprehensive terrorist watch list available for use by all Federal Government agencies. As a result of using a manual process and a limited terrorist watch list, the IRS provides only minimal assurance that tax-exempt organizations potentially involved in terrorist activities are being identified.

The IRS' manual screening of tax-exempt documents and use of a limited terrorist watch list provides minimal assurance that tax-exempt organizations potentially involved in terrorist activities are identified.

The systemic matching of a more comprehensive terrorist watch list should be considered when screening tax-exempt documents

The EO function could significantly increase its effectiveness in identifying potential terrorist financing and safeguarding the charitable sector from terrorist abuse by developing and enhancing automated systems to compare the large amount of tax-exempt data processed annually against the list of known or suspected terrorist-related organizations. Currently, IRS personnel review two key filings by tax-exempt organizations to identify potential links to terrorist activities:

- Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code (Form 1023). This Form is required by most organizations seeking to be recognized as tax exempt by the Federal Government. Generally, Forms 1023 are

⁵ References in this report to the IRS relate specifically to the IRS functions primarily responsible for screening tax-exempt organizations' filing information for terrorist-related activities. Forms 1023 are reviewed by EO function personnel in Cincinnati, Ohio. Forms 990 are reviewed by Wage and Investment Division personnel in Ogden, Utah.



*Screening Tax-Exempt Organizations' Filing Information
Provides Minimal Assurance That Potential Terrorist-Related
Activities Are Identified*

processed by EO function personnel in Cincinnati, Ohio; they began screening Forms 1023 for potential terrorist connections in October 2002, following a brief trial period.

- Return of Organization Exempt From Income Tax (Form 990).⁶ After receiving tax-exempt recognition, most organizations are required to file a Form 990 annually to report their financial transactions and activities. Form 990 is the primary source of current information on the operations of tax-exempt organizations. Generally, Forms 990 are filed at the Ogden Submission Processing Site. Currently, only Forms 990 filed by Section 501(c)(3)⁷ organizations are manually reviewed for potential terrorist-related connections. Ogden personnel began screening Forms 990 for potential terrorist connections in April 2005.

Table 1: Key Information Contained On Forms 1023 and 990

Information Provided	Form 1023	Form 990
Employer Identification Number	X	X
Articles of Incorporation	X	
Bylaws	X	
Purpose and Activities of the Organization	X	X
Revenues (and their sources)	X	X
Expenditures (and their nature)	X	X
Balance Sheet for the Most Recently Completed Tax Year	X	X
Names, Titles, and Addresses of Officers, Directors, and Trustees	X	X
Compensation Amounts	X	X
Names and Addresses of the Five Highest Paid Employees and Independent Contractors (if more than \$50,000)	X	X
Contributors to the Organization of More Than \$5,000 During the Year		X
Payments to Highly Paid Employees, Contractors, and Certain Transactions and Loans		X

Source: Forms 1023 and 990 and related instructions.

Currently, IRS personnel manually review both Forms 1023 and 990 during processing to identify individuals or organizations potentially involved in terrorist activities. They check

⁶ All future references to Form 990 in this report include Forms 990, 990-EZ, and 990-PF.

⁷ Internal Revenue Code Section 501(c)(3) (2006).



*Screening Tax-Exempt Organizations' Filing Information
Provides Minimal Assurance That Potential Terrorist-Related
Activities Are Identified*

names/organizations on these Forms against a terrorist watch list maintained by the United States Department of the Treasury Office of Foreign Assets Control (OFAC).⁸ The OFAC terrorist watch list is updated frequently. Potential matches are forwarded to an EO function Tax Law Specialist for additional review. If a match is confirmed, the case will be referred to the IRS Criminal Investigation function for review.

This manual process has identified only a small number of potential terrorist-related cases. Specifically:

- During the period January 2003 through September 2006, more than 80,000 Forms 1023 were filed annually by organizations requesting tax-exempt status. However, only 93 cases were initially identified by the EO Determinations office as having potential terrorist-related connections for the period October 1, 2005, through September 5, 2006. Three of these cases were determined to merit a further detailed terrorist-related review by the EO Technical and Quality Assurance office in Washington, D.C. One case was subsequently approved for tax-exempt status; the other two were still under review as of December 2006. EO function personnel stated that, prior to October 2005, an additional 47 cases were identified as having potential terrorist connections; however, no summary information was recorded to determine the resolution of these cases by function personnel.
- The latest available IRS statistics show charitable tax-exempt organizations filed approximately 300,000 Forms 990 for Tax Year 2003; however, only 201 were initially identified as having potential terrorist-related connections for the period April 2005 through October 2006 by Ogden Submission Processing Site personnel. After further review, IRS management determined these Forms 990 did not contain a match to the OFAC terrorist watch list.

EO function management agreed an automated process to check tax-exempt documents for possible terrorist-related connections would result in a more efficient and effective identification process. Since 2004, Tax Exempt and Government Entities Division management has been working with the Criminal Investigation function to test the systemic matching of Forms 990 Schedule of Contributors (Schedule B) data for possible terrorist connections. Division management's objective is to use more sophisticated tools to identify entities and organizations that may be associated with possible terrorists. This will be accomplished by comparing filing data against databases of multiple terrorist watch lists, including the OFAC terrorist watch list. This project is currently in the testing mode, and the implementation date is unknown. In the long term, Division management stated they would like Criminal Investigation function personnel to also systemically match Form 990 Organization Exempt Under Section 501(c)(3) (Schedule A) data (e.g., compensation, lobbying expenditures) for possible terrorist connections.

⁸ The OFAC terrorist watch list contains names of organizations, countries, and some individuals whose assets have been frozen because they have committed or pose a significant risk of committing acts of terrorism.



*Screening Tax-Exempt Organizations' Filing Information
Provides Minimal Assurance That Potential Terrorist-Related
Activities Are Identified*

The ability of the EO function to perform systemic matching of tax-exempt filing data is also limited by the amount and types of electronic data available. For tax years ending on or after December 31, 2005, a tax-exempt organization is statutorily required⁹ to electronically file Form 990 if the organization has \$100 million or more in total assets and files 250 or more returns¹⁰ a year. This requirement was expanded in 2007 to include tax-exempt organizations with total assets of \$10 million or more that file 250 or more returns a year. In Calendar Year 2006, approximately 15,000 Forms 990 were filed electronically. However, as indicated earlier, this is only a small portion of the total Forms 990 filed annually. The majority of Forms 990 are filed on paper and subsequently imaged by IRS personnel. These imaged data are not as easily matched by a systemic process as electronically filed data.

In addition, the IRS does not currently have a system to allow tax-exempt organizations to file Forms 1023 electronically. EO function management stated the electronic filing of Forms 1023 is a long-range goal; however, there are no specific plans at this time for an implementation date for this functionality. Management also indicated a system is currently being implemented that will enhance the imaging of Forms 1023 and will enable them to obtain electronically a limited amount of data that may be helpful in the screening process. This system is scheduled for full implementation in October 2007.¹¹

The development of a process that will enable the IRS to systemically match Form 990 information, as well as consideration of matching Form 1023 data when available in usable format, will significantly increase the probability of identifying potential terrorist activities related to tax-exempt organizations, allow for more effective use of IRS resources, and help preserve the public's trust in the charitable sector.

A more comprehensive terrorist watch list is available and may be more beneficial to the IRS in its screening process

After a brief test period, the EO function started using the OFAC terrorist watch list in October 2002 to identify potential terrorist organizations and/or individuals during the application screening process. However, the TSC terrorist watch list may be more beneficial to the IRS in its screening of tax-exempt organizational data. At the time of our review, we determined the OFAC terrorist watch list used by the EO function had approximately 1,600 unique terrorist/organizations names or aliases, while the TSC terrorist watch list contained more than 200,000 names suspected of being involved in terrorist activities.

⁹ 26 United States Code Section 6011 (2006).

¹⁰ Types of returns include income, excise, and employment tax as well as information.

¹¹ The Treasury Inspector General for Tax Administration is currently reviewing this system in another audit, *Review of the Tax Exempt and Government Entities Division's Development of the Tax Exempt Determination System Release 2* (Audit # 200610047).



*Screening Tax-Exempt Organizations' Filing Information
Provides Minimal Assurance That Potential Terrorist-Related
Activities Are Identified*

Department of the Treasury officials advised us that the EO function is not required to use the TSC terrorist watch list when reviewing filing data of tax-exempt organizations. According to EO function management, they decided to use the OFAC terrorist watch list because the OFAC is the key function in the Department of the Treasury responsible for carrying out the Department's responsibilities under Executive Order 13224.¹² Function management officials believe the OFAC is well positioned to identify suspicious persons who might take advantage of the financial markets to raise or divert funds for terrorist purposes or to undermine the financial system for such purposes. According to function management, the OFAC terrorist watch list identifies the organizations and individuals of primary concern to the EO function as it identifies all Specially Designated Global Terrorists, Foreign Terrorist Organizations, and Specially Designated Terrorists who are subject to economic sanctions.

In July 2002, the President issued the National Strategy for Homeland Security, which was designed to create a "comprehensive plan for using America's talents and resources to enhance our protection and reduce our vulnerability to terrorist attacks." This Strategy emphasized that no one agency or computer network at the time integrated all available homeland security information. Rather, the information was contained within several Federal, State, and local systems, and much of it was redundant or supplemental to other terrorist watch list data. HSPD-6 required the Attorney General to establish an organization to "consolidate the [Federal] Government's approach to terrorism screening and provide for the appropriate and lawful use of Terrorist Information in screening processes." Specifically, the TSC was assigned responsibility for consolidating terrorist screening information to be used by Federal, State, local, territorial, tribal, and foreign governments and private sector organizations across the country and around the world. Furthermore, this organization is required to maintain a consolidated terrorist screening database containing a sensitive but unclassified subset of the information obtained from other entities.

The intent of the consolidated list was to implement a coordinated and comprehensive approach to terrorist-related screening. The TSC supports Federal, State, local, territorial, and tribal law enforcement agencies and some foreign governments that conduct terrorist screening by making its terrorist watch list information available to them for screening purposes. In addition, HSPD-11 was signed on August 27, 2004, and required the Secretary of the Department of Homeland Security, in coordination with other Federal Government departments and agencies, to submit a report that outlines a strategy to enhance the effectiveness of terrorist-related screening activities. The report should encourage innovation that exceeds established standards; ensure flexibility to respond to changing threats and priorities; build upon existing systems and best practices and, where appropriate, integrate, consolidate, or eliminate duplicative systems used for terrorist-related screening; and enhance information flow between various screening programs.

¹² Executive Order 13224 was signed on September 23, 2001, and authorized the Federal Government to freeze the assets of foreign individuals and entities that commit or pose a significant risk of committing acts of terrorism.



*Screening Tax-Exempt Organizations' Filing Information
Provides Minimal Assurance That Potential Terrorist-Related
Activities Are Identified*

Although screening tax-exempt documents against a terrorist watch list does not guarantee the identification of all potential terrorist connections, checking against a comprehensive, consolidated terrorist watch list increases the possibility of identifying individuals already known to be or suspected of being involved in terrorist-related activities. We could not determine if there were undetected potential terrorist cases; however, we believe the EO function's use of the OFAC terrorist watch list, instead of a more comprehensive terrorist watch list, may have contributed to the small number of potential terrorist-related cases identified to date. The TSC terrorist watch list was created pursuant to HSPD-6 and should contain all information permitted by law to be maintained on the identities of individuals known or appropriately suspected to be involved in terrorist activities, while the OFAC terrorist watch list contains organizations, countries, and individuals that have had economic sanctions brought against them. Thus, it is probable that some individuals listed on the TSC terrorist watch list will not be listed on the OFAC terrorist watch list because of the different makeup of the lists. If the IRS does not use all available information to detect possible links of charities and nonprofit organizations to known or suspected terrorist organizations, there is a risk that these charities will not be reported to the Federal Government authorities fighting terrorism.

Recommendations

The Director, EO, in coordination with key IRS and external stakeholders, should:

Recommendation 1: Develop and implement a long-term strategy to automate the matching of Forms 1023 and 990 information against a consolidated terrorist watch list to initially identify potential terrorist activities related to tax-exempt organizations.

Management's Response: EO function management agreed with the recommendation and will develop a long-term strategy to automate checking of names on Forms 1023 and 990 against a terrorist watch list. Function management is currently testing and evaluating software that will check names on Forms 990; they will develop similar plans for checking names on Forms 1023.

Recommendation 2: Evaluate whether more comprehensive terrorist watch lists, including any applicable TSC information, should be used in conjunction with the Department of the Treasury OFAC list during the screening of tax-exempt filing data, to improve the identification of organizations and/or individuals potentially involved in terrorist-related activities.

Management's Response: EO function management agreed with the recommendation. They will meet with Federal Bureau of Investigation personnel to evaluate how the TSC information may serve their needs and will evaluate whether other, more comprehensive terrorist watch lists can be used.



*Screening Tax-Exempt Organizations' Filing Information
Provides Minimal Assurance That Potential Terrorist-Related
Activities Are Identified*

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to assess the EO function's efforts to identify and work cases involving tax-exempt organizations and/or related individuals potentially involved in terrorist-related activities. We reviewed the internal controls used to record and process potential terrorist-related cases identified during EO function processing and identified several minor internal control weaknesses involving tracking controls for cases. We verbally informed function management of these weaknesses during our fieldwork, and appropriate actions were taken to improve the case-tracking processes. To accomplish our objective, we:

- I. Determined the EO function's process for identifying and working cases involving tax-exempt organizations and/or related individuals potentially involved in terrorist-related activities.
 - A. Interviewed applicable function management to determine the process followed to identify and work cases involving organizations and/or individuals potentially involved in terrorist-related activities associated with determinations and information returns processing.
 - B. Obtained and reviewed any procedures developed by the function in this area.
 - C. Determined how the function ensures it is using the most current version of the OFAC terrorist watch list and determined whether employees are using it.
- II. Determined any results of the EO function's efforts to identify and work cases involving tax-exempt organizations and/or related individuals potentially involved in terrorist-related activities.
 - A. Obtained any available statistics on the function's efforts to identify organizations and/or individuals potentially involved in terrorist-related activities including the number of staff involved, volume of all determination applications¹ and information returns processed (including amended returns), and any other pertinent statistical data.
 - B. Identified any information on the number of determination applications and information returns that were identified by function staff as having possible terrorist-related activities.

¹ To be exempt as a charitable nonprofit entity, an organization must file an application for recognition of exemption with the IRS (Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code (Form 1023)).



*Screening Tax-Exempt Organizations' Filing Information
Provides Minimal Assurance That Potential Terrorist-Related
Activities Are Identified*

- C. Determined the number and status of referrals made by the function to other entities resulting from the function's identification of organizations and/or individuals potentially involved in terrorist-related activities.
- III. Determined the adequacy of the EO function's coordination efforts with other IRS divisions or external entities to help in its efforts to identify and work cases involving tax-exempt organizations and/or related individuals potentially involved in terrorist-related activities.
- A. Identified types of data (e.g., data from States, the Department of State, and the OFAC terrorist watch list) received from and provided to other entities and how often this occurs.
 - B. Determined the status of the Criminal Investigation function's efforts to develop a database that will facilitate electronic queries and analysis of Returns of Organization Exempt From Income Tax (Form 990) Schedule of Contributors (Schedule B) contributor information to identify potential terrorist-related activities.



*Screening Tax-Exempt Organizations' Filing Information
Provides Minimal Assurance That Potential Terrorist-Related
Activities Are Identified*

Appendix II

Major Contributors to This Report

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*Screening Tax-Exempt Organizations' Filing Information
Provides Minimal Assurance That Potential Terrorist-Related
Activities Are Identified*

Appendix III

Report Distribution List

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Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Commissioner, Wage and Investment Division SE:W
Deputy Commissioner, Tax Exempt and Government Entities Division SE:T
Deputy Commissioner, Wage and Investment Division SE:W
Chief, Criminal Investigation SE:CI
Director, Customer Account Services, Tax Exempt and Government Entities Division
SE:T:CAS
Director, Customer Account Services, Wage and Investment Division SE:W:CAS
Director, Exempt Organizations, Tax Exempt and Government Entities Division
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 Senior Operations Advisor, Wage and Investment Division SE:W:S



*Screening Tax-Exempt Organizations' Filing Information
Provides Minimal Assurance That Potential Terrorist-Related
Activities Are Identified*

Appendix IV

Management's Response to the Draft Report



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

RECEIVED
MAY 03 2007

MAY 02 2007

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM:

Richard M. Story
for Steven T. Miller

Commissioner, Tax-Exempt and Government Entities

SUBJECT:

Screening Tax-Exempt Organizations Filing Information
Provides Minimal Assurance That Potential Terrorist-
Related Activities Are Identified (Audit #200610044)

We have reviewed your draft report on the Exempt Organization function's program to screen the annual information returns and exemption applications it receives for names of potential terrorists.

Since 2002, we have reviewed all Forms 1023, filed by applicants for section 501(c)(3) status, to check for possible terrorist-related connections. Since early 2005, we have undertaken a similar review of all incoming Forms 990, the annual information return filed by exempt organizations.

Since 2004, we have worked with the Criminal Investigations Division to test computer-based systems for matching filed Form 990 Schedule of Contributors (Schedule B) data for possible terrorist-related connections.

We recognize the benefit of using an effective computer-based system to search these submissions, and have an active program underway to acquire, test, and implement such a system. Your recommendations complement our effort, and we agree with both of them.

If you have any questions concerning this response, please contact David L. Fish at (202) 283-8909.

Attachment



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Activities Are Identified*

2

Recommendation 1:

The Director, Exempt Organizations, in coordination with key IRS and external stakeholders, should develop and implement a long-term strategy to automate the matching of Forms 1023 and 990 information against a consolidated terrorist watch list to initially identify potential terrorist activities related to tax-exempt organizations.

Corrective Action:

We agree with this recommendation. We will develop a long-term strategy to automate checking of names on Forms 1023 and Forms 990 against a terrorist list. We are currently testing and evaluating software products that will check names found on Form 990 against a terrorist list. We will develop similar plans for checking names on Form 1023.

Implementation Date:

July 1, 2008, for development of strategy. Date for implementation of strategy will depend on the technology selected and related considerations.

Responsible Official:

Director, Business Systems Planning.

Recommendation 2:

Evaluate whether more comprehensive terrorist watch lists, including any applicable Terrorist Screening Center information, should be used in conjunction with the Department of Treasury's OFAC list during screening of tax-exempt filing data to improve the identification of organizations and/or individuals potentially involved in terrorist-related activities.

Corrective Action:

We agree with this recommendation. We will meet with FBI personnel to evaluate how the Terrorist Screening Center information may serve our needs, and we will evaluate the efficacy of using other more comprehensive lists.

Implementation Date:

December 31, 2008

Responsible Official:

Director, Exempt Organizations Rulings and Agreements