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Should Religious Organizations Worry About IRS Audits?

by Sarah J. Webber and Janet S. Greenlee

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Introduction

A great deal of media attention has focused on recent perceived financial abuses of churches and religious organizations. Cases of fraud within religious organizations have fueled the public perception that churches require some form of monitoring to prevent financial abuse. However, the IRS has limited authority to audit religious organizations under section 7611, and the results of such audits are generally unavailable to the public.

Through a Freedom of Information Act request, we obtained the outcomes of all section 7611 IRS audits of religious organizations conducted between 2001 and 2010. We found that although the number of both churches and nonchurch-related organizations (NCROs) increased significantly during the period examined, the number of IRS audits did not rise.

We also analyzed religious organizations' chances of being selected for an IRS examination and the likely outcome of an examination. In most cases the audits ended with no change to the organization's status, or a delinquent tax return was secured.

This information is useful for churches that may face or are currently under IRS examination. Further, this information can help tax practitioners assess examination outcomes and advise clients.

What Is a Church?

Surprisingly, the Internal Revenue Code does not define a "church." Within the code, a church is any organization claiming to be a church (section 7611(h)(1)(A)) and any convention or association of churches (section 7611(h)(1)(B)). This definition may be intentionally vague to recognize the many different types of churches.

In 1978, IRS Commissioner Jerome Kurtz provided a 14-factor test the IRS has used when determining whether an entity is a church:

1. a distinct legal existence;
2. a recognized creed and form of worship;
3. a definite and distinct ecclesiastical government;
4. a formal code of doctrine and discipline;
5. a distinct religious history;
6. a membership not associated with any other church or denomination;
7. an organization of ordained ministers;
8. ordained ministers selected after completing prescribed studies;
9. a literature of its own;
10. established place of worship;
11. regular congregation;
12. regular religious services;
13. Sunday school for religious instruction of the young; and
14. schools for the preparation of ministers.¹

It is very common for a church to have an affiliated organization that is recognized as a separate entity for tax purposes, which we refer to as an NCRO. The corresponding treasury regulations state, "A church doesn't include church-supported schools or other organizations incorporated separately from the church." (Reg. section 301.7611-1, Q&A 3). Therefore, it is possible to have both a church and an NCRO that are counted separately within IRS statistical data even though the two entities' operations are entwined.

How Many Churches and NCROs Are There In the United States?

There is no widely accepted measurement for the total number of combined religious organizations within the United States. According to the U.S. Census Bureau, there were 325,901 churches and religious organizations in 2010. However, only those organizations voluntarily submitting data that have memberships (determined by the organizations) of at least 60,000 are included in this database (U.S. Census Bureau, National Council of Churches USA (2010)). Because only large religious organizations are included in this database, the actual number of entities claiming church or nonchurch religious status

¹IRS Commissioner Jerome Kurtz remarks at the PLA Seventh Biennial Conference on Tax Planning, Jan. 9, 1978.

with the IRS may be understated significantly when relying on the U.S. Census figure.

Many additional sources of church data exist. The Association of Religious Data Archives reported in 2000 that there were 268,240 congregations in the United States representing 149 religious denominations.² The Hartford Institute for Religion Research, relying on the Religious Congregations and Membership Study 2010 Census, claimed that roughly 350,000 congregations existed in the United States in 2010.³ Neither organization included NCROs in its data.

In 2005, C. Kirk Hadaway (director of research for the Episcopal Church) and Penny Marler (professor of religion, Samford University) determined that the number of churches within the United States is approximately 330,765.⁴ They based this measurement on known membership totals for Protestant, Roman Catholic, and Orthodox churches and proportionally accounted for all other religious denominations, based on a 1999 National Congregations study.

In summary, no official listing of all churches exists in the United States. Thus, according to the Hartford Institute for Religion Research, researchers must rely on statistical estimates extrapolated from surveys. For the purposes of our analysis, we rely on Hadaway and Marler's (2005) estimate of churches and, accounting for a slight increase, we estimated the number of churches in the United States at 335,000 as a constant for each year of the study.

IRS Authority to Audit Churches

Under section 7611, a church may be subject to IRS audit for very limited reasons, including potential violation of the restriction against unrelated business activity or other activities subject to federal tax, engaging in political campaign activity or excess benefit transactions, or possible lack of religious purpose to qualify the entity for exemption. The code also permits deductions of church donations for business and individual taxpayers on their respective income tax returns. This deductibility makes maintaining tax-exempt status a key deterrent to preventing fraudulent churches. The threat of an IRS audit also helps ensure churches are legitimate. The granting of tax-exempt status and IRS religious organization audit results are explored in more detail below.

FOIA Data

A FOIA request was submitted to the IRS to obtain data on examinations and exemption requests for churches and NCROs between 2001 and 2010. We requested the numbers of exemptions granted, withdrawn, and denied, and we asked for detailed information about the denials. Although the IRS does not maintain data on

²Available at <http://www.thearda.com/RCMS2010/>.

³Available at http://hrr.hartsem.edu/research/fastfacts/fast_facts.html.

⁴Hadaway, C., and Marler, P. (2005), "How Many Americans Attend Worship Each Week? An Alternative Approach to Measurement," *Journal for the Scientific Study of Religion*, 44(3), 307-322.

Table 1. 2001-2010 Number of IRS Organizational Approvals for Tax-Exempt Status

Year	Churches	Non-churches	Total
2001	4,126	4,903	9,029
2002	5,074	5,251	10,325
2003	5,088	5,554	10,642
2004	4,577	5,446	10,023
2005	4,179	5,109	9,288
2006	4,223	4,933	9,156
2007	4,382	5,378	9,760
2008	3,618	4,328	7,946
2009	4,256	4,268	8,524
2010	3,793	3,505	7,298
Total	43,316	48,675	91,991
Mean	4,331.6	4,867.5	9,199.1
Standard Deviation	479.4	648.45	1,055.25

the number of denials or withdrawn requests, the agency did give us data on the number of exemptions granted and detailed information on audit outcomes for churches and NCROs. We analyzed the data to determine the frequency and resolution of the IRS audits.

Granting Exempt Status

Despite the difficulty in determining the number of churches and religious organizations within the United States, one source that provides accurate measurement is the number of exemptions the IRS grants to religious organizations on an annual basis. To compare churches and NCROs, the number of churches and the number of NCROs requesting exemption was analyzed. The results are in Table 1.

Total exemptions granted to religious organizations were 91,991 during the 10-year period. These exemptions were divided between churches (47 percent) and NCROs (53 percent).

It is important to note that the number of churches granted exemption does not represent the total number of new churches. Churches are not required to apply for exempt status. However, many churches still apply even though they have no legal obligation under the code to do so. Churches may choose to apply in order to provide transparency to their members or to satisfy financing requirements.

Most exemptions were granted in the first half of the period studied. The year 2003 was the highest year, with 10,642 exemptions granted, followed by 2002 (10,325 exemptions) and 2004 (10,023 exemptions). The lowest number of exemptions granted, 7,298, occurred in 2010. The average for all religious organizations from 2001 through 2010 was 9,199.

This information provides insight into the rate at which the NCROs are growing within the United States and also demonstrates the total number of churches applying for exempt status every year. The mean number of churches granted exemption shows that numerous churches have decided to apply for exemption and register with the IRS. Unfortunately, as stated above, it is

not possible to document the total number of new churches for a given year. This data show fairly constant growth in number for all religious organizations during the period analyzed.

Quantifying Audit Likelihood for Churches

According to the IRS's 2010 Data Book, 1.11 percent of returns filed by individuals (more than 1.5 million out of nearly 143 million) were selected for audit.⁵ Also in 2010, the IRS processed 776,300 exempt organization⁶ returns, 11,449 of which were under examination during fiscal year 2010, resulting in an audit selection rate of 1.47 percent.⁷ While a comparison of the individual audit selection rate (1.11 percent) and the exempt organizations rate (1.47 percent) seems to show that exempt entities are audited at a higher rate than individuals, this comparison is misleading for the reasons addressed below.

In calculating the number of exempt organization returns filed, the IRS did not consider the number of Form 990-N returns, the mandatory electronic notices filed by entities receiving \$25,000 or less in annual gross receipts. There are no statistics available on the number of Form 990-N returns filed, but it is believed the number could be as many as 500,000.⁸ Failing to include the Form 990-N filers in the total exempt organization returns filed greatly reduces the potential number of exempt organization returns filed.

The second reason the 1.47 percent IRS audit rate of exempt organizations is unreliable is because churches do not have a mandatory information return filing requirement. A church is required to file an information return only if it has registered with the IRS as a section 501(c)(3) tax-exempt entity. As discussed earlier, a church may, but is not required to, apply for 501(c)(3) status. Due to the exclusion of the Form 990-N from the IRS audit rate statistics as well as the lack of a filing requirement for churches, it is estimated that the audit percentage of exempt organizations is significantly lower than the 1.47 percent rate based on the IRS Data Book.

Table 2 presents a more accurate portrayal of the audit rates for churches than the 1.47 percent rate. Relying on our estimated number of churches in the United States as 335,000 for each year of the study, we determined the audit risk for churches over the 10-year period was .014 percent.

⁵This amount also includes more than 134,000 examinations for failure to file a tax return. (See Table 9a, "Examination Coverage: Recommended and Average Recommended Additional Tax After Examination, by Type and Size of Return," Fiscal Year 2010, and Table 9b, "Examination Coverage: Individual Income Tax Returns Examined by Size of Adjusted Gross Income.")

⁶Unfortunately, the IRS Data Book provides neither a breakdown of different tax-exempt organizations nor the results of IRS audits of these organizations.

⁷See Table 13, "Returns of Tax-Exempt Organizations, Employee Plans, Government Entities, and Tax-Exempt Bonds Examined by Type of Return," Fiscal Year 2010, available at <http://www.irs.gov/taxstats/>.

⁸See discussion of Form 990 filings available at <http://www.nolo.com/legal-encyclopedia/nonprofits-file-irs-form-990-n-tax-exempt-32211.html>.

Year	Total Number of IRS Audits	Total Number of Churches	Probability of IRS Audit
2001	17	335,000	0.005075%
2002	17.5	335,000	0.005224%
2003	8.5	335,000	0.002537%
2004	19.5	335,000	0.005821%
2005	31	335,000	0.009254%
2006	23	335,000	0.006866%
2007	38.5	335,000	0.011493%
2008	106	335,000	0.031642%
2009	71.5	335,000	0.021343%
2010	146	335,000	0.043582%
Total Number of IRS Audits	478.5	Mean Probability of IRS Audit	0.014284%

We compared our calculated church audit risk to the IRS Data Book individual audit rate of 1.11 percent. This comparison showed that church audits were 70 times less likely than the average individual rate. This analysis indicates that IRS examination efforts are not spread evenly and that religious organizations have a significantly lower audit risk than individual taxpayers.

Historical Trends for Audit Outcomes of Churches

When an examination concludes, the IRS must label the case as one of 18 outcomes. These outcomes, or "disposal codes," are delineated in Table 3. Table 4 shows the total number of audits open or disposed of during the 10-year period was 478.5. Of those audits, the vast majority of examinations for churches did not result in the revocation of exempt status. Almost 31 percent of IRS church audits were resolved with a disposal code of 02, or "no change," while approximately 31 percent closed under disposal code 06 for a "delinquent return secured." These results indicate that the majority of church audits either lead to a clean audit report from the IRS or the filing of a Form 990 information return the church had failed to file on time.

The likely reason for the significant number of delinquent returns secured is that there have been changes to Form 990 filing rules, including the 990-N requirement, beginning in tax year 2008. Of the 146.5 audits resolved through delinquent returns secured, almost all occurred in the last three years of the study, suggesting that churches may have had difficulty adjusting to the new Form 990-N requirements.

While more than 60 percent of audits are resolved without a negative consequence to churches, the next most frequent outcome was disposal code 03, "Agreed Tax or Penalty Change," in approximately 13 percent of the audits. The specific penalties or taxes charged to churches within this disposal code remain unknown. However, this disposal code indicates that when the IRS did assess a penalty or tax, it was much more common for the church to agree with that determination than appeal.

Table 3. Disposal Code Titles and Descriptions for Tables 4 and 5

Disposal Code and Title	Description
01 — Regulatory/ Revenue Protection	This code should be used to close an examination with (1) an agreed claim disallowance, (2) a reduction to a net operating loss (NOL) that does not affect the tax liability or (3) the closing of a barred statute.
02 — No Change	This code should be used to close an examination with no changes or adjustments (all significant return information is complete and correct) or when unable to complete a church examination within the two-year period provided by section 7611(c)(1)(A) of the code. This code also should be used to close an examination with: (1) a change to income and/or deduction items reported on the return, with no tax adjustment; or (2) an adjustment that could be made but is not because the defect is within acceptable tolerances.
03 — Agreed Tax or Penalty Change	This code should be used to close an examination of a return with an agreed tax/penalty assessment and over-assessments.
04 — Change to Related Return	This code should be used to close an examination in which an adjustment to a related return is proposed. This includes discrepancy adjustments made to related returns and examined EO-related returns in which an adjustment is proposed.
05 — Delinquent Related Return Secured	This code should be used to close an examination of a primary return, e.g., Form 990, Form 990-PF, if a delinquent related return is secured.
06 — Delinquent Return Secured	This code should be used to close an examination of a secured and examined delinquent related return, e.g., Form 990-T. This code should be used to close an examination of the primary return, e.g., Form 990, only if it is a secured delinquent return.
07 — Unagreed — Protest to Appeals	This code should be used to close an examination if the issue is unagreed and the taxpayer timely files a protest.
08 — Written Advisory — Form 5666	This code should be used to close an examination of a return when the examination discloses some aspect of an organization's activities or operations, which if enlarged or ongoing, may jeopardize the organization's exempt status. This code should only be used in situations deemed sufficiently significant to warrant the preparation of Form 5666 to recommend a subsequent year examination.
09 — Revocation — Agreed	This code should be used to close an examination that results in an agreed revocation.
10 — Unagreed — Without Protest	This code should be used to close an examination in which there is an unagreed issue and the taxpayer fails to file a timely protest.
12 — Closing Agreement	This code should be used to close an examination in which an executed closing agreement is secured.
13 — Referrals to Other Operating Divisions	This code should be used to close an examination in which a referral (proposed adjustment) is made to the IRS Large & Mid-Size Business Division, Small Business/Self-Employed Division, or Wage & Investment Division.
14 — Termination Agreed	This code should be used to close an examination in which a termination letter is issued.
15 — Church Examination — Unagreed	This code should be used to close an examination that results in an unagreed revocation of exempt status or unagreed modification of private foundation status of a church.
17 — Change in Foundation Status — Agreed	This code should be used to close an examination of a section 501(c)(3) organization that results in an agreed change to the organization's private foundation status, e.g., change from section 509(a)(1) to section 509(a)(2) or change from a public charity to a private foundation.
19 — Amendment Secured	This code should be used to close an examination in which an executed amendment relating to a qualification issue (e.g., 501(c)(3) dissolution clause) is secured.
50 — Agreed Intermediate Sanction Payments	This code should be used to close an examination with an agreed intermediate sanction payment under section 4958.
52 — Written Advisory — No Form 5666	This code should be used to close examinations that issue written advisories but do not require either a Form 5666 or follow-up action.

In very few instances did the church disagree with the IRS audit outcome; only 1.25 percent of audits were resolved with either an "Unagreed — Protest to Appeals" (disposal code 07) or "Church Examination — Unagreed" (disposal code 15). It is also important to note the difference between the two unagreed categories. Disposal code 15 is used when a church does not agree with the changes proposed under audit but fails to file a timely protest. This amount was significantly higher (20 instances) than the amount under disposal code 07 (three instances), suggesting that churches often fail to take an unagreed change to appeals.

Thus, the audit results suggest practitioners need to ensure they are advising exempt organizations on their rights under the IRS appeals process. The exact cause of churches failing to appeal unagreed changes is unknown but there are several possibilities. It is possible the church lacks the knowledge and financial resources to pursue the appeals process. However, it also may be that churches ending up with an unagreed position are unable to assess their likelihood of success on appeal and decide it is not economically prudent to appeal. Further, it is unclear what the IRS's response would be to an unagreed audit that is not appealed. The church may be concerned that the unagreed audit without an appeal may signal

Table 4. Church IRS Exempt Organizations Audits and Outcomes for 2001-2010*

Exempt Organizations Examination Research												
IRS Audits of Churches												
As of February 18, 2011												
Disposal Code and Description**	By Fiscal Year											Percentage of Total
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Total	
Open Examination				1.5		1.5	1.5	1.5	7	28	41	8.57%
01 — Regulatory/ Revenue Protection	1.5										1.5	0.31%
02 — No Change	11	13	7	12	20	7	16	52	8	1.5	147.5	30.83%
03 — Agreed Tax or Penalty Change	1.5	1.5		1.5	8	6	7	20	5	10	60.5	12.64%
04 — Change to Related Return	1.5					4	1.5				7	1.46%
05 — Delinquent Related Return Secured				1.5				1.5	1.5		4.5	0.94%
06 — Delinquent Return Secured						1.5		19	37	89	146.5	30.62%
07 — Unagreed — Protest to Appeals						1.5				1.5	3	0.63%
08 — Written Advisory — Form 5666					1.5		1.5				3	0.63%
09 — Revocation — Agreed					1.5						1.5	0.31%
10 — Unagreed — Without Protest			1.5				4	7	6	1.5	20	4.18%
12 — Closing Agreement		1.5							1.5	13	16	3.34%
15 — Church Examination — Unagreed				1.5				1.5			3	0.63%
17 — Change in Foundation Status — Agreed	1.5	1.5							1.5		4.5	0.94%
19 — Amendment Secured				1.5							1.5	0.31%
52 — Written Advisory — No Form 5666					1.5	1.5	4	5	4	1.5	17.5	3.66%
Total by Year	17	17.5	8.5	19.5	31	23	38.5	106	71.5	146	478.5	100.00%

* IRS data provided listed “occurrences two or less.” When this description occurred in the data, 1.5 was used as an estimated amount.
** Disposal Code and Description were provided by the IRS based on their examination disposal coding system. A detailed explanation of the codings is provided in Table 3.

that the church could lose its status as a church entity and its exemption in the future.

Historical Trends for Audit Outcomes of NCROs

The outcomes of IRS audits of NCROs rely on the same listing of disposal codes provided in Table 3 with the addition of three new disposal codes: code 13, “Referrals to Other Operating Divisions”; code 14, “Termination Agreed”; and code 50, “Agreed Intermediate Sanction Payments.” In Table 5, the number of NCRO audits was slightly higher (569.5 audits) than the total for churches (478.5 audits), resulting in 91 (or 9 percent)

more audits undertaken for NCROs than for churches over the same 10-year period.

The total number of NCRO audits shows similar results to the church data, namely, that most NCRO audits result in no negative consequence to the organization. The most likely outcome for an NCRO audit was disposal code 02, representing 38 percent of the audits. The next most frequent disposal code was 52, “Written Advisory — No Form 5666,” accounting for slightly more than 22 percent of the NCRO audits. Disposal code 52 is used when an audit is resolved without any follow-up IRS action and often is used as a warning to NCROs to

Table 5. Nonchurch Religious Organizations: IRS Exempt Organizations Audits and Outcomes for 2001-2010*

Exempt Organization Examination Research IRS Audits of Nonchurch Religious Organizations As of February 18, 2011												
Disposal Code and Description**	By Fiscal Year											Percentage of Total
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Total	
Open Examination						1.5			9	36	46.5	8.17%
01 — Regulatory/ Revenue Protection					1.5						1.5	0.26%
02 — No Change	11	20	64	18	26	20	32	17	5	4	217	38.10%
03 — Agreed Tax or Penalty Change			1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	12	2.11%
04 — Change to Related Return	1.5	1.5			1.5	1.5	1.5	1.5			9	1.58%
05 — Delinquent Related Return Secured		1.5	1.5	1.5	1.5	1.5	4	1.5	1.5	1.5	16	2.81%
06 — Delinquent Return Secured				1.5	1.5	8	14	9	10	15	59	10.36%
07 — Unagreed — Protest to Appeals	1.5	1.5	1.5	1.5		1.5	1.5				9	1.58%
08 — Written Advisory — Form 5666	1.5	1.5	1.5		1.5	1.5	6	1.5	1.5	1.5	18	3.16%
09 — Revocation — Agreed				1.5	4	1.5		1.5			8.5	1.49%
10 — Unagreed — Without Protest			1.5				1.5	1.5	1.5		6	1.05%
12 — Closing Agreement										1.5	1.5	0.26%
13 — Referrals to Other Operating Divisions		1.5									1.5	0.26%
14 — Termination Agreed			1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	12	2.11%
17 — Change in Foundation Status — Agreed		6	5	1.5		1.5	1.5		5		20.5	3.60%
19 — Amendment Secured			1.5						1.5		3	0.53%
50 — Agreed Intermediate Sanction Payments		1.5									1.5	0.26%
52 — Written Advisory — No Form 5666			1.5	1.5	22	25	35	20	16	6	127	22.30%
Total by Year	15.5	35	81	30	62.5	66.5	100	56.5	54	68.5	569.5	100.00%

* IRS data provided listed "occurrences two or less." When this description occurred in the data, 1.5 was used as an estimated amount.
** Disposal Code and Description were provided by the IRS based on their examination disposal coding system. A detailed explanation of the codings is provided in Table 3.

correct their reporting in the future or to request additional information from the NCRO to help the IRS close the audit file. This disposal code does not result in a negative consequence beyond a slap on the wrist from the IRS.

Another similarity in the NCRO data to the church data is the frequency of missing a required information

return filing. The disposal code 06 occurred in more than 10 percent of the NCRO audits. This coding showed a slight increase between 2008 and 2010, but not nearly as significant as the church code data for the same period. This comparison suggests the changes to the Form 990 filings had a much larger impact on churches than on NCROs.

Only a very limited number of NCRO audits actually result in a negative consequence to the organization. Of NCROs, 4 percent of audits ended in revocations of exempt status (code 09) or termination of the NCRO (code 14). Meanwhile only 2 percent of NCRO audits ended in an agreed tax or penalty change (code 03). This suggests that NCROs guilty of abusing exempt status have agreed with the IRS's decision to revoke exemption or other penalties assessed in most instances rather than appeal. An appeal occurred in less than 1 percent of the NCRO audit outcomes.

Conclusion

The IRS data we analyzed support the common belief that religious entities are audited less frequently than the audits of other taxpayers, particularly the audits of individual taxpayers. In addition to the decreased frequency of audit, religious organizations are not likely to see a substantial negative outcome from an IRS examination.

For churches and religious organizations under IRS examination, the data suggest the examination is most likely to result in no change to the exempt status or tax due for the organization. The IRS's best tool for compliance is the threat of revocation or assessment of tax on a religious organization. The data suggest the likelihood of revocation or assessment of tax is very small. This may result from the fact that almost all religious organizations are legitimate nonprofit entities that should be granted exempt status, but it is also possible the IRS has not been targeting the religious entities that are abusing their exempt status.

Regardless of the explanation, this low-risk outcome puts the voluntary compliance approach of the IRS in jeopardy. On the bright side, for legitimate religious organizations that fulfill the conditions of their exempt status, these data also indicate that they are at low risk for negative audit outcomes and should not panic if selected for an IRS examination.