EXEMPT ORGANIZATIONS: The IRS Continues to Struggle with Revocation Processes and Erroneous Revocations of Exempt Status

RESPONSIBLE OFFICIAL

Sunita B. Lough, Commissioner, Tax Exempt & Government Entities Division

DEFINITION OF PROBLEM

The IRS’s Exempt Organization (EO) unit receives about 60,000 applications for exempt status each year.1 In addition, EO receives applications for reinstatement from organizations whose exempt status was automatically revoked. These applications added more than 50,000 cases to EO’s workload over the past three years.2 Already understaffed, EO did not allocate more resources to its Determinations Unit, which processes both initial and reinstatement applications. Its inventory backlog now stands at about 66,000 cases, more than the number of initial applications it usually receives in an entire year, four times the 2010 level, and more than triple the 2011 level.3 Organizations consulting the “Where is My Exemption Application?” page on IRS.gov are informed that applications requiring review by an EO specialist take a year and a half just to be assigned.4

There is no procedure for administrative review of automatic revocations, yet EO uses automated systems that erroneously identify thousands of organizations as no longer exempt.5 Planned programming changes will not avert future erroneous revocations. By erroneously listing an organization as having lost its tax exempt status, the IRS may cause the organization to lose funding it needs to survive and the effect may be community-wide. In today’s difficult economy and in light of long-term cuts in projected spending known as sequestration, exempt organizations are faced with a gap between an increasing need for their assistance and diminishing

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1 Public Charity Organizational Issues, Unrelated Business Income Tax, and the Revised Form 990, Hearing before the H. Comm. on Ways and Means, Subcomm. on Oversight, 112th Cong., 2nd Sess. (July 25, 2012) 2 (testimony of Steven T. Miller, Deputy Commissioner of Services and Enforcement, Internal Revenue Service), available at http://waysandmeans.house.gov/uploadedfiles/miller_testimony_7_25.pdf (noting that “We consistently receive about 60,000 applications for tax-exempt status each year. Most are requesting status under section 501(c)(3).”).

2 Total EO determinations case receipts were 66,038 for fiscal year (FY) 2011; 79,362 for FY 2012; and 79,740 for FY 2013. IRS response to TAS fact check, referencing TE/GE’s fourth quarter 2013 Business Performance Review (BPR) (Dec. 16, 2013).


4 Where Is My Exemption Application?, available at http://www.irs.gov/Charities-&-Non-Profits/Where-Is-My-Exemption-Application (informing taxpayers as of Nov. 14, 2013, that EO was assigning applications it received in May of 2012). The web page was last updated on Sept. 23, 2013. Organizations consulting the more recently updated “Where’s My Application?” page on IRS.gov are informed that the IRS might take up to six months after acknowledgment of the application to either inform the applicant that the application has been approved or to request additional information. See Where’s My Application, available at http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Where’s-My-Application%3F (last visited Dec. 17, 2013, showing the page had been updated Dec. 11, 2013). This new webpage was first available around Nov. 1, 2013. See Systemic Advocacy Management System submission 28938. Because six months have not yet elapsed since then, TAS cannot verify the reliability of the six-month estimate.

5 TE/GE estimates it erroneously treated about 9,000 organizations as having had their exempt status automatically revoked. TE/GE response to TAS information request (Nov. 12, 2013).
resources available to meet that need. The single largest category of public charities deliver human services — they “provide networks of direct services to people in need. They feed our hungry, strengthen our communities, shelter our homeless, care for our elderly, and nurture our young.” When charities lose funds because they cannot obtain timely recognition of their exempt status, or are erroneously treated as no longer exempt, these vulnerable populations suffer the consequences.

**ANALYSIS OF PROBLEM**

**Background**

EO Has Struggled for the Past Decade to Process Its Inventory of Applications for Exempt Status, and Automatic Revocations Made the Problem Worse.

Since 2004, the National Taxpayer Advocate has reported on the increased number of applications for exempt status and the decrease in the number of EO employees who handle them. Three of the past six Annual Reports to Congress identified the delay in processing applications for exempt status as among the Most Serious Problems. EO’s workload grew substantially in 2010, when it began notifying organizations their exempt status had been automatically revoked. Many of these organizations applied for reinstatement, and they have done so in increasing numbers. EO, however, had projected a decrease in the number of applications for reinstatement over time. Figure 1.15.1 shows the relationship between EO’s projected and actual receipts of reinstatement applications.

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8 National Taxpayer Advocate 2004 Annual Report to Congress 193, 203 (Most Serious Problem: Application and Filing Burdens on Small Tax-Exempt Organizations).

9 National Taxpayer Advocate 2012 Annual Report to Congress 192 (Most Serious Problem: Overextended IRS Resources and IRS Errors in the Automatic Revocation and Reinstatement Process Are Burdening Tax-Exempt Organizations); National Taxpayer Advocate 2011 Annual Report to Congress 442 (Most Serious Problem: The IRS Makes Reinstatement of an Organization’s Exempt Status Following Revocation Unnecessarily Burdensome); National Taxpayer Advocate 2007 Annual Report to Congress 210 (Most Serious Problem: Determination Letter Process).

10 Section 1223 of the Pension Protection Act of 2006 (PPA) (Pub. L. No. 109-280, 120 Stat. 780 (2006)) imposed a new annual reporting requirement, Form 990-N, *Electronic Notice (e-Postcard) for Tax-Exempt EOs Not Required to File Form 990 or 990-EZ*, on small exempt organizations and mandated automatic revocation of tax-exempt status of organizations that fail to file required returns or e-Postcards for three consecutive years.
EO and the IRS also ignored TAS’s repeated warnings that EO was seriously understaffed to handle the influx of applications, with the result that applications continue to outstrip EO resources, as shown by Figure 1.15.2.\textsuperscript{12}

\textbf{FIGURE 1.15.2, Applications for Reinstatement of Exempt Status and Full-time Cincinnati Staff Handling the Applications FY 2011–2013\textsuperscript{13}}


\textsuperscript{12} EO does not assign specific employees to work only on applications for reinstatement. TE/GE response to TAS information request (Nov. 12, 2013).

\textsuperscript{13} TE/GE response to TAS information request (Nov. 12, 2013) noting that “all Exempt Organizations, Determinations (EOD) and Exempt Organizations, Technical (EOT) employees who work on applications may work on reinstatement requests” and “[t]he approximate number of employees in EOD working applications is 150. The approximate number of employees in EOT working applications is 30.” TAS found that as of Oct. 5, 2013, there were 183 full-time Cincinnati Determinations staff. AWSS Employee Support Services, Payroll/Personnel Systems, HR Reporting Section, available at https://persinfo.web.irs.gov/track/workorg.asp.
EO’s budget as a portion of TE/GE’s budget hovered between 35 and 38 percent for FYs 2011-2013 and remained relatively stable in dollar terms, but EO’s volume of open inventory (i.e., total unresolved cases) more than tripled.14 According to the “Where is My Exemption Application?” page on IRS.gov, applications that need development take 18 months to be assigned to a reviewer, up from the nine months cited in last year’s Annual Report and the seven months cited in the 2011 Annual Report.15

Organizations affected by delays in obtaining recognition of exempt status include those that deliver human services such as food and shelter. Of public charities that report to the IRS, there are more in this category than in any other.16 Increased need for their assistance coincides with reductions in the amount of government funds to meet the need, especially at the state and local levels. For example, according to a 2012 survey by the U.S. Conference of Mayors:17

1. Over 80 percent of the survey cities reported an increase in requests for emergency food assistance over the past year and three fourths expect such requests to increase in the future.18

2. Nearly half of the survey cities expect that resources to provide emergency food assistance will decrease over the next year.19

3. More than half the survey cities reported an increase in the total number of persons experiencing homelessness and expect the number of homeless families to increase in the future.20

4. More than half of the survey cities expect resources to provide emergency shelter to decrease over the next year.21

The difficulties organizations encounter in obtaining timely recognition of their exempt status directly affects the members of their communities most in need of assistance.

**EO erroneously notified thousands of organizations their exempt status had been revoked.**

Since the first automatic revocations became effective in 2010, EO has notified about 550,000 organizations they are no longer exempt, with about 9,000 of these notifications being in error.22 The IRS notes the loss of exempt status on an electronic list of organizations whose exempt status was automatically

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14 EO’s budget equaled $98,759,800 or 35.6 percent of TE/GE’s budget in FY 2011; $100,547,400 or 37.2 percent in FY 2012; and $97,154,000 or 38.1 percent in FY 2013; TE/GE response to TAS information request (Nov. 12, 2013). For FY 2011, the level of open inventory was 20,603 cases compared to the FY 2013 level projected to be 66,000 cases. IRS response to TAS fact check, referencing TE/GE’s fourth quarter 2013 Business BPR (Dec. 16, 2013).

15 See National Taxpayer Advocate 2012 Annual Report to Congress 196 (Most Serious Problem: Overextended IRS Resources and IRS Errors in the Automatic Revocation and Reinstatement Process Are Burdening Tax-Exempt Organizations); National Taxpayer Advocate 2011 Annual Report to Congress 449; Where Is My Exemption Application?, available at http://www.irs.gov/Charities-&-Non-Profits/Where-Is-My-Exemption-Application (informing taxpayers that, as of Nov. 14, 2013, EO was assigning applications it received in May of 2012). The web page was last updated on Sept. 23, 2013.

16 Sarah L. Pettijohn, Urban Institute, The Nonprofit Sector in Brief 4 (2013), available at www.urban.org/UploadedPDF/412923-The-Nonprofit-Sector-in-Brief.pdf. Of the 335,037 public charities reporting to the IRS in 2011, 116,643 (35 percent) were classified as part of the human services subsector. The next largest category included the 58,568 educational organizations (17.5 percent of the total), followed by the 41,619 health organizations (12.4 percent of the total). All other classifications (arts, culture and humanities; environment and animals; international and foreign affairs; public and social benefit; and religion related) each accounted for less than 12 percent of the total.


18 Id., at 1-2, reporting that 82 percent of the cities reported an increase in requests for emergency food assistance and three fourths of the survey cities expect requests for emergency food assistance to increase over the next year.

19 Id., at 2, reporting that 48 percent expect that resources to provide emergency food assistance will decrease over the next year.

20 Id., at 2-3, reporting that 60 percent of the cities reported an increase in homelessness and 60 percent expect the number of homeless families to increase over the next year.

21 Id., at 3, reporting that 58.5 percent of the cities expect resources to provide emergency shelter to decrease over the next year.

22 TE/GE response to TAS information request (Nov. 12, 2013); IRS response to TAS fact check (Dec. 16, 2013).
revoked and removes the organization from the list of organizations to which deductible contributions may be made. An organization will likely immediately suffer the consequences of being taken off the “right” list and placed on the “wrong” list, while it faces potentially lengthy timeframes in the reinstatement process. EO refuses to implement a review procedure that would avert these drastic consequences long enough to allow it to consider the possibility that the revocation might have been erroneous. In the meantime, an organization may become ineligible for grants and may lose donor funding it needs to survive.

As described in last year’s Annual Report, after the Treasury Inspector General for Tax Administration found a programming problem existed, EO identified more than 2,270 cases in which an organization was erroneously listed as having had its exempt status revoked, and 300 to 400 additional entities identified themselves as erroneously listed as revoked. The most common reason for the erroneous revocations was that IRS systems did not recognize subordinate organizations as part of a group return when the subordinates and the parent organizations had different accounting periods. This year, EO reported to TAS additional programming conditions that caused erroneous revocations. As reported in the National Taxpayer Advocate’s Fiscal Year 2014 Objectives Report to Congress, one programming change caused IRS computers to calculate the three-year nonfiling period that triggers automatic revocation only with reference to the date the organization obtained its Employer Identification Number (EIN). An organization obtaining its EIN in 2007, for example, would be treated as having had reporting obligations since 2007, even if the organization commenced operations and obtained recognition of its exempt status only in 2011. Systemic review of filing activity would show three or more consecutive years of nonfiling (2007-2010) and EO would notify the organization that it was no longer exempt. EO does not track the number of organizations it treated as automatically revoked because of this issue.

EO relies on affected organizations to come forward and seek relief, then rectifies an error by restoring the organization’s exempt status on its databases and issuing a letter attesting to its exempt status. In an effort to minimize erroneous revocations, EO plans to change its procedures by identifying taxpayers who, in the process of obtaining an EIN, indicate they are nonprofit organizations. The IRS will then send these organizations that do not file returns Notice 259A. The notice does not actually remind (or inform)

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24 Id. at 199.
25 National Taxpayer Advocate Fiscal Year 2014 Objectives Report to Congress 33 (June 30, 2013). An EIN is a nine-digit number assigned by the IRS to sole proprietors, corporations, partnerships, estates, trusts, and other entities for tax filing and reporting purposes. An organization requests an EIN by submitting IRS Form SS-4, Application for Employer Identification Number (EIN). The form does not require that the organization already be operational. For example, the applicant may select “banking purpose” as the reason for applying for the EIN. Thus, a new organization might obtain an EIN, set up a business bank account, and then use a check or credit card from the business bank account to pay the incorporation fee imposed by the state in which the organization is created. The EIN application asks what type of entity the applicant is, and contains a box for “other nonprofit organization.”
26 TE/GE response to TAS information request (Nov. 12, 2013).
27 TE/GE response to TAS information request (Nov. 12, 2013).
28 Id. This capability is expected to be available beginning in January of 2014.

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able to file a return or e-Postcard without assistance from the IRS.\(^{32}\) This solution will not help taxpayers whose EIN applications do not show they are nonprofits. As noted above, it also does not help taxpayers who, although they have an EIN, have not commenced operations or do not respond to the IRS’s notice because they do not believe it applies to them.

A separate programming change affected reinstated organizations. IRS databases did not show that organizations whose exempt status had been reinstated had a new three-year automatic revocation period. This caused the IRS to revoke exempt status a second time shortly after granting reinstatement.\(^{33}\) The IRS does not know how many organizations it treated as automatically revoked because of this change.\(^{34}\) While the IRS has resolved the problem for many of these organizations, it does not know how many it may have overlooked.\(^{35}\) EO requested programming changes that will essentially suspend the three-year nonfiling period while the organization’s exempt status remains automatically revoked. If approved, the changes will be implemented in January of 2015.\(^{36}\) As the National Taxpayer Advocate has repeatedly pointed out, administrative review of all proposed automatic revocations (rather than the current ad hoc and nonpublic approach) would likely have averted many errors.\(^{37}\)

**CONCLUSION**

EO’s inventory backlog, which now exceeds the number of initial applications it usually receives in an entire year, burdens taxpayers who must wait for 18 months for their applications to be assigned to an analyst. Thousands of organizations were forced to cope with EO’s troubled inventory management only because EO erroneously treated them as having had their exempt status automatically revoked and they were required to apply for reinstatement. EO is aware that measuring the three-year nonfiling period with reference to the EIN date causes erroneous revocations, yet it intends to retain that practice. It does not adequately inform organizations how the practice may affect them or provide organizations any way to seek administrative review of automatic revocations.

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32 TE/GE response to TAS information request (Nov. 12, 2013). In fact, as described above, the IRS will issue these taxpayers notice CP 259A to notify them they did not file a return.

33 Upon learning that EO programming was causing erroneous revocations, TAS issued guidance to its employees explaining how to identify and advocate for taxpayers who come to TAS with these problems.

34 TE/GE response to TAS information request (Nov. 12, 2013).

35 Id.

36 Id.

37 National Taxpayer Advocate 2012 Annual Report to Congress 192 (Most Serious Problem: Overextended IRS Resources and IRS Errors in the Automatic Revocation and Reinstatement Process Are Burdening Tax-Exempt Organizations); National Taxpayer Advocate 2011 Annual Report to Congress 442 (Most Serious Problem: The IRS Makes Reinstatement of an Organization’s Exempt Status Following Revocation Unnecessarily Burdensome); National Taxpayer Advocate 2011 Annual Report to Congress 562 (Legislative Recommendation: Provide Administrative Review of Automatic Revocations of Exempt Status, Develop a Form 1023-EZ, and Reduce Costs to Taxpayers and the IRS by Implementing Cyber Assistant).
RECOMMENDATIONS

The National Taxpayer Advocate recommends the IRS:

1. Issue a letter informing the organization when the IRS proposes to treat it as having had its exempt status automatically revoked and providing an opportunity to correct the condition that caused the proposed automatic revocation within 30 days. The letter should specify the availability of administrative review for organizations raising concerns that the IRS is proceeding in error.

2. When notifying organizations that they did not submit a required return or e-Postcard, inform them that EO calculates the three-year nonfiling period using the date the organization obtained its EIN. Advise them to contact EO if its use of the EIN date may result in an erroneous revocation.

3. Do not include in the three-year nonfiling period for purposes of automatic revocations any period for which an organization could not submit an e-Postcard without contacting the IRS.