

Area of  
Focus #8

## The IRS Approves Many Applications for Tax-Exempt Status Almost Automatically, Often Based on Insufficient Information

### TAXPAYER RIGHTS IMPACTED<sup>1</sup>

- *The right to be informed*
- *The right to finality*

Taxpayers seeking exempt status as IRC § 501(c)(3) organizations have applied for recognition using IRS Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, for over 30 years.<sup>2</sup> Revisions to the form have made it more comprehensive (it is now 12 pages long, not counting required schedules or attachments, compared to nine pages in 1998).<sup>3</sup> Because “[f]or many if not most small [exempt organizations], one or two pages of questions that elicit basic information would suffice,” the National Taxpayer Advocate recommended the Tax Exempt and Government Entities division (TE/GE) design a Form 1023-EZ smaller organizations could use.<sup>4</sup> The IRS has now adopted a shorter form, but the form has gone too far in the opposite direction by “eliciting” only a series of checkmarks in boxes. As discussed in last year’s Objectives Report, in July 2014, the IRS adopted Form 1023-EZ, *Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, over the objections of the National Taxpayer Advocate and various stakeholder groups.<sup>5</sup> Because Form 1023-EZ does not require applicants to provide supporting documentation or substantiation, but only to attest they qualify for exempt status, the IRS has in effect relinquished its power to educate and regulate taxpayers before it confers exempt status.

TE/GE recognizes its new approach carries compliance risks, which it intends to address by auditing organizations it already recognized as exempt.<sup>6</sup> While audits are certainly a legitimate method of ascertaining whether an organization is or continues to be exempt, the National Taxpayer Advocate believes helping taxpayers meet the requirements for exempt status from inception, prior to granting recognition of exempt status, is the most effective approach for increasing cost effectiveness, reducing taxpayer burden, and enhancing consumer protection.

1 See IRS, Taxpayer Bill of Rights, available at <http://www.irs.gov/Taxpayer-Bill-of-Rights>.

2 See, e.g., Office of Information and Regulatory Affairs, Office of Management and Budget, Information Collection Request Ref. No. 198104-1545-056, approving a 1981 revision of the form.

3 See, e.g., Jack Siegel, *Re-Engineering Form 1023 to Identify Problem Organizations Before Exemption Is Granted: Watch out for the “Penalties of Perjury” Statement* (Nov. 3, 2004), commending the IRS for “attempting to identify those organizations that are likely to violate the rules governing Section 501(c)(3) organizations before granting tax-exempt status rather than relying on an audit process that is currently underfunded and spotty.”

4 National Taxpayer Advocate 2011 Annual Report to Congress 448 (Status Update: *The IRS Makes Reinstatement of an Organization’s Exempt Status Following Revocation Unnecessarily Burdensome*). Noting that Form 1023 requires the applicant to “[l]ist the names, titles, and mailing addresses of each of your five highest compensated employees who receive or will receive compensation of more than \$50,000 per year,” for example, the National Taxpayer Advocate suggested a Form 1023-EZ that simply asks if any employees receive more than \$50,000 per year in compensation from the organization. If so, the EO could be required to file the full Form 1023. *Id.*, n. 44.

5 See National Taxpayer Advocate Fiscal Year (FY) 2015 Objectives Report to Congress 54-57.

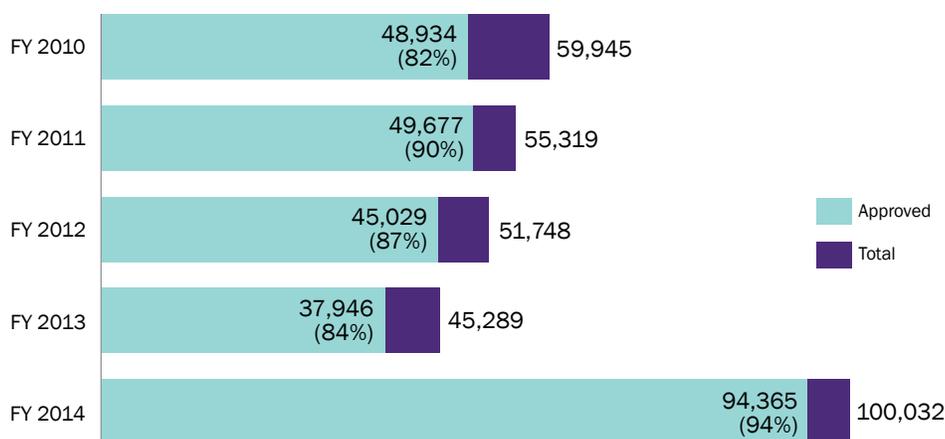
6 See, e.g., TE/GE Business Performance Review (BPR) First Qtr. 2015 Appendix B, TE/GE Risk Register (Feb. 2015) available at <https://organization.ds.irsnet.gov/sites/tege-cl/Strategic%20Planning/BPRs/FY2015/TEGE%20BPR%201st%20Quarter%20FY%202015.pdf>, noting that “[p]erceived inadequate oversight of the tax-exempt sector as we undertake strategic shifts in how we conduct the up-front review of applications for tax-exempt status...” will be mitigated by “[e]xpanded compliance efforts.”

### In 2014, the Volume of IRS Exempt Status Determinations As Well As the Approval Rate Increased

Figure 3.8.1 shows the number of determinations and approval rates TE/GE's Exempt Organizations (EO) function made each year on applications for exempt status under IRC § 501(c)(3) from FYs 2010 through 2014. Between 82 and 94 percent of IRC § 501(c)(3) applications received approval during this period. From 2010 through 2013, the IRS made determinations for fewer than 60,000 applications each year. The IRS doubled the number of 1023 determinations it made in a year from FY 2013 to 2014.

**FIGURE 3.8.1**<sup>7</sup>

#### Determinations of Exempt Status as Section 501(c)(3) Organizations



In January and February of 2014, EO adopted streamlined procedures for processing applications from organizations seeking section 501(c)(3) exemptions.<sup>8</sup> The procedures allowed certain aspects of the application to be “developed through attestation” (*i.e.*, by relying on the applicant’s affirmation) rather than on the basis of substantiating documents.<sup>9</sup> In July 2014, the IRS introduced Form 1023-EZ, available to certain organizations with annual gross receipts of \$50,000 or less, which consists entirely of attestations. As EO worked through its backlog of cases using these procedures, the number of determinations of exempt status under section 501(c)(3) rose to 100,000 in 2014, and the rate of approval increased to 94 percent.<sup>10</sup>

<sup>7</sup> Table 24, *Closures of Applications for Tax-Exempt Status, by Organization Type and Internal Revenue Code Section*, IRS Data Books, 2010-2014.

<sup>8</sup> See *Proposal to Apply the Concepts from the Streamlined Application Process Pilot to Existing Inventory*, attached to TE/GE-07-0215-0005, *Reissued Streamlined Processing Guidelines for All Cases* (Feb. 27, 2015) and TE/GE-07-0214-02, *Streamlined Processing Guidelines for All Cases* (Feb. 28, 2014).

<sup>9</sup> On Dec. 9, 2013, EO provided TAS with a detailed description of the streamlined process. See SAMS Submission 28975.

<sup>10</sup> See, e.g., TE/GE BPR, Fourth Qtr. 2014 at 16-17 (Nov. 2014) available at <https://organization.ds.irsnet.gov/sites/tege-cl/Strategic%20Planning/BPRs/FY2014/TEGE%20BPR%204th%20Quarter%20FY%202014.pdf>, noting, “At the end of FY 2014 [Sept. 30, 2014], we have a total of 22,759 cases in open inventory, which is a 65 percent decrease from the end of FY 2013. We worked each case more efficiently due to the implementation of streamlined processing.”

The information on the e-Postcard [Form 990-N] is insufficient to allow a potential donor or researcher to determine whether the organization actually conducts exempt activities. Thus, Form 1023-EZ and Form 990-N, even taken together, provide almost no transparency.

Since the launch of Form 1023-EZ, the approval rate for applications submitted on this form alone has been 95 percent.<sup>11</sup> More than half (51 percent) of all applications for recognition as a section 501(c)(3) organization are now submitted on Form 1023-EZ.<sup>12</sup> The annual reporting requirement of organizations recognized as exempt on the basis of Form 1023-EZ is generally Form 990-N (e-Postcard), an electronic submission that provides only eight pieces of information.<sup>13</sup> The information on the e-Postcard is insufficient to allow a potential donor or researcher to determine whether the organization actually conducts exempt activities. Thus, Form 1023-EZ and Form 990-N, even taken together, provide almost no transparency.

### TE/GE's Analysis of a Random Sample of Form 1023-EZ Applicants Demonstrates EO Erroneously Grants Exempt Status

In response to concerns raised by the National Taxpayer Advocate, TE/GE agreed as it introduced Form 1023-EZ, it would require additional documentation from a representative sample of applicants and would review the information before making a determination.<sup>14</sup> The purpose of this pre-determination review would be “[t]o address the concern that information collected would be insufficient to make a correct determination.”<sup>15</sup> The method would be “to take a statistical sampling of the [Form 1023-EZ] applications and put them through the more rigorous process, to see if they’ve answered the questions correctly, or whether they’ve, in fact, if they’d gone through the 26-page questionnaire [Form 1023], would have been not qualified, whereas that looks like they’re qualified.”<sup>16</sup> Over the first six months after the release of Form 1023-EZ, TE/GE selected 521 organizations for pre-determination review as part of a representative sample, and by February 2015, had made determinations in 411 cases.<sup>17</sup> As part of the review, EO employees rejected applications from

- 11 See TE/GE BPR Second Qtr. 2015 at 5 (May 2015), First Qtr. 2015 at 2 (Feb. 2015), and Fourth Qtr. 2014 at 2 (Nov. 2014), all reporting approval rates of 95 percent for Form 1023-EZ applications.
- 12 TE/GE BPR Second Qtr. 2015 at 5 (May 2015) available at <https://organization.ds.irsnet.gov/sites/tege-cl/Strategic%20Planning/BPRs/FY2015/TEGE%20BPR%202nd%20Quarter%20FY%202015.pdf>, noting that for the second quarter of FY 2015, Form 1023-EZ applications constituted 51 percent of total applications for recognition as section 501(c)(3) organizations.
- 13 Form 990-N, which may be filed by organizations with annual gross receipts of normally \$50,000 or less, requires the organization’s employer identification number (EIN); the tax year; the organization’s legal name and mailing address; any other names the organization uses; the name and address of a principal officer; the website address if the organization has one; confirmation the organization’s annual gross receipts are \$50,000 or less; and if applicable, a statement the organization has terminated or is terminating (going out of business). IRS, *Information Needed to File E-Postcard*, available at <http://www.irs.gov/Charities-&Non-Profits/Information-Needed-to-File-e-Postcard>. Because an e-Postcard does not contain sufficient data to calculate tax liability or determine tax-exempt status, and does not purport to be a return, “the filing of a complete Form 990 or Form 990-EZ, rather than the submission of an annual electronic notification, is the filing of a return that starts the period of limitations for assessment under section 6501(g)(2).” Treas. Reg. § 1.6033-6(c)(4). See also T.D. 9366, 2007-52 I.R.B. 1232, 1233.
- 14 See National Taxpayer Advocate FY 2015 Objectives Report to Congress 56, urging TE/GE to evaluate a representative sample of organizations whose applications had been approved pursuant to EO’s streamlined procedures to determine whether those organizations were actually compliant. See also Rev. Proc. 2014-40, 2014-30 I.R.B. 229, sec. 5.03, providing that “the Service will select a statistically valid random sample of Forms 1023-EZ for pre-determination reviews.”
- 15 TE/GE, *Form 1023-EZ Six-Month Pulse Check 6*, presented to and discussed with the National Taxpayer Advocate on April 21, 2015.
- 16 William Hoffman, *An Interview With IRS Commissioner John Koskinen*, 2014 TNT 147-2 (July 29, 2014).
- 17 TE/GE, *Form 1023-EZ Six-Month Pulse Check 5*, presented to and discussed with the National Taxpayer Advocate on April 21, 2015. Additional organizations are selected for pre-determination review over time and added to the representative sample. By March 31, 2015, the total number of organizations selected for pre-determination review was 844, and while the number of rejected applications was reported, as discussed below, TE/GE was not able to identify the total number of cases for which a determination had been made. TE/GE BPR Second Qtr. 2015 at 34 (May 2015) available at <https://organization.ds.irsnet.gov/sites/tege-cl/Strategic%20Planning/BPRs/FY2015/TEGE%20BPR%202nd%20Quarter%20FY%202015.pdf>.

applicants ineligible to file a Form 1023-EZ and those that had not used a valid EIN in the application.<sup>18</sup> EO agents requested additional information from remaining applicants, to be submitted under penalties of perjury, including “the organizing document with language required to meet the organizational test; a detailed description of past, present, and future activities; revenues and expenses; and a detailed description of any transactions with donors or related entities.”<sup>19</sup> If the responses were not forthcoming, EO rejected the applications.<sup>20</sup>

As Figure 3.8.2 shows, out of 411 organizations in the sample for which a determination had been made, 301 were recognized as section 501(c)(3) organizations.<sup>21</sup> This approval rate – 73 percent – is far lower than the 95 percent rate for Form 1023-EZ filers generally.<sup>22</sup> As noted, out of the 521 applications in the sample, 110 had not yet been closed by the time TE/GE reported the partial results of its pre-determination review. Even if EO ultimately approves all remaining sample cases, however, the approval rate would only be 79 percent.<sup>23</sup>

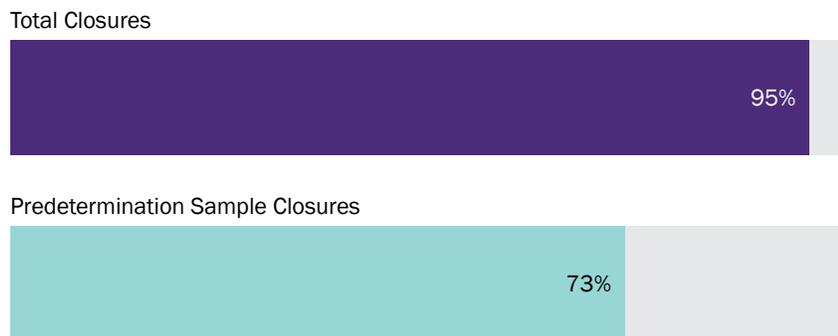
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**Because Form 1023-EZ does not require applicants to provide supporting documentation or substantiation, but only to attest they qualify for exempt status, the IRS has in effect relinquished its power to educate and regulate taxpayers before it confers exempt status.**

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**FIGURE 3.8.2<sup>24</sup>**

**Form 1023-EZ Approval Rates (through Dec. 26, 2014)**



18 Of the closed sample cases, 28 percent were ineligible to submit Form 1023-EZ, usually because actual or projected gross receipts exceeded \$50,000. TE/GE, *Form 1023-EZ Six-Month Pulse Check* 5, presented to and discussed with the National Taxpayer Advocate on April 21, 2015.

19 TE/GE, *Form 1023-EZ Six-Month Pulse Check* 4, presented to and discussed with the National Taxpayer Advocate on April 21, 2015.

20 Rejected Form 1023-EZ applications are not final determinations for purposes of the declaratory judgment provisions of IRC § 7428. Rev. Proc. 2014-40, sec. 6, 2014-30 I.R.B. 229, 234 (July 21, 2014).

21 TE/GE’s pre-determination procedures provide “[a]n organization’s application can be approved, rejected, or denied. An organization’s application for exempt status is denied if the IRS determines that the organization does not meet the organizational or the operational test.” TE/GE, *Form 1023-EZ Six-Month Pulse Check* 2, n. 1, presented to and discussed with the National Taxpayer Advocate on April 21, 2015.

22 Moreover, as Figure 3.8.2 shows, the overall approval rate for Form 1023 applications from FY 2011-2014 ranged from 82 to 94 percent.

23 With the remaining 110 approvals, total approvals would be 411 of 521, or 78.9 percent.

24 Based on data reported in TE/GE, *Form 1023-EZ Six-Month Pulse Check*, Tables 2 and 4, presented to and discussed with the National Taxpayer Advocate on April 21, 2015.

In other words, by adopting Form 1023-EZ, EO approved section 501(c)(3) applications it would have rejected had the applications been subject to the slightest scrutiny. Because the cases selected for pre-determination review were part of a representative sample, the findings of the review can be projected to the entire population of Form 1023-EZ applications.<sup>25</sup> TE/GE reported through the second quarter of FY 2015, it closed 30,601 Form 1023-EZ applications, approving 29,069, or 95 percent, of them.<sup>26</sup> Based on the findings of the pre-determination review showing the approval rate for Form 1023-EZ applications subjected to more scrutiny was only 73 percent, we expect only 22,411 of the 30,601 Form 1023-EZ applications should have been approved. The discrepancy between the number of Form 1023-EZ applications that were approved (29,069) and the expected number that should have been approved (22,411) was 6,658, representing an error rate of more than 21 percent.<sup>27</sup>

As noted above, by March 31, 2015, there were 844 cases in EO's representative sample of organizations selected for pre-determination review.<sup>28</sup> TE/GE was not able to specify the number of reviews that have been completed, but reported EO rejected 150 applications in the sample.<sup>29</sup> Of the 150 applications EO rejected, one of the most frequent reasons for rejection was the applicant was ineligible to file a Form 1023-EZ. The instructions to Form 1023-EZ and the accompanying Eligibility Worksheet identify certain organizations as ineligible to use Form 1023-EZ even though they may qualify for exempt status.<sup>30</sup> These organizations must apply for exempt status using Form 1023 instead. Form 1023-EZ applicants attest they have completed the Eligibility Worksheet and are eligible to submit Form 1023-EZ. Nevertheless, at least 41 percent of the rejected applications were from organizations ineligible to use Form 1023-EZ. The main reasons for their ineligibility were:

- Gross receipts were expected to exceed \$50,000 in any of the next three years (21 percent of the rejections were for this reason);
- The application was submitted more than 15 months after automatic revocation by an organization seeking retroactive reinstatement (11 percent of the rejections were for this reason); and
- Annual gross receipts exceeded \$50,000 in any of the past three years (nine percent of the rejections were for this reason).<sup>31</sup>

Had additional questions not been asked of these organizations, EO would have granted them exempt status despite the demonstrably incorrect attestations and even though TE/GE has determined that as a rule, applications from organizations in that class should receive greater scrutiny. Consumer and taxpayer protections would have simply been bypassed in these cases, as they presumably were in other applications that did not receive the additional scrutiny.

25 TE/GE's description of its pre-determination review does not include the level of confidence associated with the sample findings or the margin of error, but the number of applications in the sample suggest a level of confidence of 95 percent and a five percent margin of error.

26 TE/GE BPR Second Qtr. 2015 at 34 (May 2015) available at <https://organization.ds.irsnet.gov/sites/tege-cl/Strategic%20Planning/BPRs/FY2015/TEGE%20BPR%202nd%20Quarter%20FY%202015.pdf>.

27 6,658 is 21.8 percent of 30,601.

28 TE/GE BPR Second Qtr. 2015 at 34 (May 2015) available at <https://organization.ds.irsnet.gov/sites/tege-cl/Strategic%20Planning/BPRs/FY2015/TEGE%20BPR%202nd%20Quarter%20FY%202015.pdf>.

29 TE/GE response to TAS information request (June 11, 2015); TE/GE BPR Second Qtr. 2015 at 34-36 (May 2015) available at <https://organization.ds.irsnet.gov/sites/tege-cl/Strategic%20Planning/BPRs/FY2015/TEGE%20BPR%202nd%20Quarter%20FY%202015.pdf>.

30 Eligibility requirements are also set out in Rev. Proc. 2014-40, sec. 2, 2014-30 I.R.B. 229.

31 Some applicants were ineligible for other reasons, but the frequency of rejection for another reason (e.g., because the applicant was a credit counseling organization, or had \$250,000 in assets) was usually less than one percent and comprised less than five percent of rejections overall.

Failure to respond to EO's request for further information by the due date represented 41 percent of rejections, or more than 60 organizations. Lack of response from organizations does not inspire confidence they have sufficient infrastructure to operate a tax-exempt organization subsidized by all U.S. taxpayers.<sup>32</sup>

### Anecdotal Evidence Supports the Conclusion EO Erroneously Recognizes Organizations as Tax-Exempt

TAS recently selected for review 13 corporations that:

- Obtained recognition as section 501(c)(3) organizations in March 2015 on the basis of a Form 1023-EZ; and
- Are located in states in which corporations' articles of incorporation are available for online inspection free of charge.<sup>33</sup>

The states from which the organizations were selected were Alaska (five organizations), Colorado (four organizations), and Ohio (four organizations). TAS reviewed each organization's articles of incorporation to determine whether they contained an adequate purpose clause and dissolution clause sufficient to meet the organizational test described in the regulations under section 501(c)(3).<sup>34</sup> In some states, sometimes referred to as *cy pres* states, an organization can also meet the dissolution provision requirement if, by operation of state law or court action, its assets would be distributed for one or more exempt purposes, or to the federal government, or to a state or local government, for a public purpose, even though a specific dissolution provision is not contained in its creating document.<sup>35</sup> Ohio is one such state.<sup>36</sup>

TAS found:

- Only three of the 13 organizations met the organizational test for section 501(c)(3) organizations;<sup>37</sup>
- The inadequacy of the purpose clause alone precludes tax-exempt status as a section 501(c)(3) organization in eight cases;
- The lack or inadequacy of a required dissolution clause alone precludes tax-exempt status as a section 501(c)(3) organization in six cases; and

32 To its credit, EO attempted to contact these unresponsive organizations, and the rate of rejections due to unresponsiveness has decreased. From Jan. 24-Mar. 27, 2015, only six applications were rejected on this basis. TE/GE BPR Second Qtr. 2015 at 35-36 (May 2015) available at <https://organization.ds.irsnet.gov/sites/tege-cl/Strategic%20Planning/BPRs/FY2015/TEGE%20BPR%202nd%20Quarter%20FY%202015.pdf>.

33 Many (more than 20), but not all, states make corporations' articles of incorporation viewable online free of charge. EO is investigating whether it could obtain, free of charge, electronic access to all state articles of incorporation. TE/GE BPR, Third Qtr. 2014 at 4 (Aug. 2014) available at <https://organization.ds.irsnet.gov/sites/tege-cl/Strategic%20Planning/BPRs/FY2014/TEGE%20BPR%203rd%20Quarter%20FY%202014.pdf>.

34 The organizing document must limit the purposes of the organizations to one or more exempt purposes; not expressly empower the organization to engage, other than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes; and must permanently dedicate the organization's assets to section 501(c)(3) purposes on dissolution. Treas. Reg. §§ 1.501(c)(3)-1(b)(1)(i)(a), (b); 1.501(c)(3)-1(b)(4).

35 See Treas. Reg. § 1.501(c)(3)-1(b)(4). *Cy pres* is "[t]he equitable doctrine under which a court reforms a written instrument with a gift to charity as closely to the donor's intention as possible, so that the gift does not fail." Black's Law Dictionary (9th ed. 2009).

36 Rev. Proc. 82-2, 1982-1 C.B. 367.

37 TAS did not inquire into the operations of any of the 13 organizations. The three organizations that met the organizational test did not necessarily meet the operational test, also required for tax-exempt status as section 501(c)(3) organizations. See Treas. Reg. § 1.501(c)(3)-1(c)(1), providing that "[a]n organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3)." If an organization fails either the organizational test or the operational test, it is not exempt. Treas. Reg. § 1.501(c)(3)-1(a)(1).

- In five cases, organizations had neither an adequate purpose clause nor an adequate dissolution clause.

Figure 3.8.3 below summarizes the findings of the review of 13 cases.

**TABLE 3.8.3, Findings of the Review of 13 Cases**

Finding	Cases
Purpose Clause and Dissolution Clause (if required) Both Sufficient	3
Purpose Clause Sufficient, But Required Dissolution Clause Insufficient	1
Purpose Clause Insufficient, But Dissolution Clause Not Required (or if required, Sufficient)	3 (all in <i>cy pres</i> state)
Both Purpose Clause and Dissolution Clause (if required) Insufficient	5
Not Found on State Website	1
<b>Total</b>	<b>13</b>

### FOCUS FOR FISCAL YEAR 2016

- Analyze the articles of incorporation of a representative sample of corporations that obtained exempt status on the basis of Form 1023-EZ from July 1, 2014, when Form 1023-EZ was introduced, through March 31, 2015. To the extent the analysis demonstrates Form 1023-EZ is an insufficient basis on which to make a determination whether an organization qualifies as a section 501(c)(3) organization, TAS will recommend corrective changes to Form 1023-EZ; and
- Review the procedures TE/GE develops for its post-determination audits of exempt organizations, recommending changes as appropriate, and reviewing the outcome of the audits.