

Study of the Extent to Which the IRS Continues to Erroneously Approve Form 1023-EZ Applications

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EXECUTIVE SUMMARY

Organizations recognized by the IRS as exempt under Internal Revenue Code (IRC) § 501(c)(3) may be exempt from federal tax, and contributions to them may be tax deductible. For decades, Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, was the IRS form organizations used to request recognition of IRC § 501(c)(3) status. Form 1023-EZ, Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, was introduced in 2014. It is a truncated version of Form 1023, consisting mainly of checkboxes, and requires applicants to attest, rather than demonstrate, that they meet the requirements for IRC § 501(c)(3) status.

One of the requirements for IRC § 501(c)(3) status is that the organization satisfy an “organizational test,” which generally means its organizing document (articles of incorporation, for a corporation) must contain adequate purpose and dissolution clauses. Form 1023-EZ applicants are not required to submit their organizing documents to the IRS; they merely attest that the organizational test has been met. Although some states make articles of incorporation available online at no charge, the IRS does not retrieve and review these publicly-available articles of incorporation when it evaluates a Form 1023-EZ application (unless the application is one that is randomly selected for pre-determination review).

In 2015, 2016, and 2017, TAS studied representative samples of articles of incorporation for corporations from 20 states that make articles of incorporation viewable online at no cost and whose Form 1023-EZ had been approved by the IRS during the preceding year. The studies found that between 26 percent and 42 percent of the time, the approved organizations did not meet the organizational test and thus did not qualify for the exempt status the IRS had conferred. In 2019, TAS repeated the study and found that 46 percent of the approved organizations did not qualify for IRC § 501(c)(3) status.

The 2019 study also found that some states provide form, or template, articles of incorporation. Depending on the template, corporations that use the template are virtually guaranteed to meet, or fail to meet, the organizational test. A review of other information that applicants provide on Form 1023-EZ, such as their websites, may provide useful insight about whether the organization qualifies for exempt status.

Form 1023-EZ was revised in 2018 to require applicants to provide a description (in 255 characters or less) of their mission or most significant activities. However, according to IRS procedures, the described mission or activities need only be “within the scope of IRC § 501(c)(3)” to be deemed sufficient. According to the 2019 study results, the IRS made erroneous determinations more frequently after it added the description field.

INTRODUCTION

Under IRC § 501(a) and (c)(3), organizations devoted to charitable, religious, educational, or certain other purposes may be exempt from federal tax, and contributions to these organizations may be tax deductible.¹ To receive tax exemption, and for their donors to receive the benefit of an income tax deduction, organizations generally must formally apply for recognition of their tax-exempt status and file annual information returns or notices.² For over 70 years, Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, was the only IRS form used for applying for recognition of IRC § 501(c)(3) status.³

If an applicant for exempt status fails either the “organizational test” or the “operational test,” it is not an organization described in IRC § 501(c)(3) and is subject to taxation on its income.⁴

The organizational test requires an applicant’s “organizing document” (articles of incorporation, for a corporation) to establish that it is “organized and operated exclusively” for one of the eight exempt purposes enumerated in IRC § 501(c)(3):⁵

- Religious;
- Charitable;
- Scientific;
- Testing for public safety;
- Literary;
- Educational;
- To foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment); or

-
- 1 IRC § 170(c). The estimated cost of permitting donors to deduct their contributions to IRC § 501(c)(3) organizations is more than \$260 billion over the five-year period from 2017-2021. See JOINT COMM. ON TAX’N, *Estimates of Federal Tax Expenditures for Fiscal Years 2017-2021*, JCX-34-18 (May 25, 2018) 40, 42, 43, estimating tax expenditures of \$46.2 billion attributable to deductions for charitable contributions to educational institutions; \$24.6 billion attributable to deductions for charitable contributions to health organizations; and \$190.3 billion attributable to deductions for charitable contributions other than for education and health, totaling \$261.1 billion. The statistical information in this research study was not provided or reviewed by the Secretary under IRC § 6108(d). See IRC § 7803(c)(2)(B)(ii)(XII).
 - 2 IRC § 508(a); IRC § 6033 (a)(1). Churches, their integrated auxiliaries, and conventions or associations of churches are excepted from these application and filing requirements. IRC § 508(c)(1)(A); IRC § 6033 (a)(3)(A)(i). In addition, Congress excused exempt organizations that are not private foundations and whose gross receipts are normally not more than \$5,000 from applying for recognition. IRC § 508(c)(1)(B). The general obligation to file annual returns or notices applies to all organizations exempt under IRC § 501(a), not only those described in IRC § 501(c)(3).
 - 3 A reference to Form 1023 as a means of applying for recognition of exempt status appeared in regulations as early as 1942. T.D. 5125, *Section 19.101-1: Proof of Exemption*, 1942-1 C.B. 101 (1942). Form 1023 was at that time captioned simply “Exemption Application.”
 - 4 Treas. Reg. § 1.501(c)(3)-1(a)(1).
 - 5 IRC § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(b)(1)(i). Treas. Reg. § 1.501(c)(3)-1(b)(4) provides that “[a]n organization is not organized exclusively for one or more exempt purposes unless its assets are dedicated to an exempt purpose. An organization’s assets will be considered dedicated to an exempt purpose, for example, if, upon dissolution, such assets would, by reason of a provision in the organization’s articles or by operation of law, be distributed for one or more exempt purposes...” Moreover, “an organization does not meet the organizational test if its articles or the law of the State in which it was created provide that its assets would, upon dissolution, be distributed to its members or shareholders.” In states that have adopted the *cy pres* doctrine, a nonprofit corporation’s articles need not include a specific dissolution provision because by operation of state law or court action the organization’s assets would be distributed upon dissolution for one or more exempt purposes, or to the federal government, or to a state or local government, for a public purpose.

- For the prevention of cruelty to children or animals.⁶

The operational test is met if the organization engages primarily in activities which accomplish one or more of the eight exempt purposes specified in IRC § 501(c)(3); no more than an insubstantial part of its activities is not in furtherance of an exempt purpose; and it is operated to further public rather than private interests.⁷

Form 1023 applicants must demonstrate they meet the requirements for exempt status by providing:

- Responses to “core” questions, including questions about financial data;
- Copies of organizing documents and copies of certain contracts with third parties; and
- Additional schedules, depending on the applicant’s characteristics (*e.g.*, a school is required to complete Schedule B, and a hospital is required to complete Schedule C).

In 2014, the IRS introduced Form 1023-EZ, Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code. Generally, organizations with total assets up to \$250,000 and those expecting annual gross receipts up to \$50,000 are eligible to use Form 1023-EZ to apply for recognition of exempt status.⁸ However, certain organizations (*e.g.*, churches, schools, and hospitals) are ineligible to use Form 1023-EZ and must seek IRC § 501(c)(3) status by filing Form 1023.⁹

Form 1023-EZ consists of a series of checkboxes that allow applicants to simply attest they meet the requirements for exempt status. Applicants are not required or even permitted to submit substantiating documentation, such as organizing documents, with the application.

6 Further, to qualify as an IRC § 501(c)(3) organization, no part of the organization’s net earnings can inure to the benefit of any private shareholder or individual (IRC § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(c)(2)); the organization cannot devote more than an insubstantial part of its activities to attempting to influence legislation by propaganda or otherwise attempting to influence legislation (IRC § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(b)(3)(i)); and the organization cannot participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office (IRC § 501(c)(3)).

7 See Treas. Reg. § 1.501(c)(3)-1(c)(1), (d)(1)(ii).

8 Rev. Proc. 2019-5, § 6.05, 2019-1 I.R.B. 230 (Jan. 2, 2019).

9 *Id.*

BACKGROUND

In 2015 and 2016, TAS studied representative samples of corporations in 20 states that made articles of incorporation viewable online at no cost and whose Form 1023-EZ application had been approved.¹⁰ The studies showed, respectively, that 37 percent and 26 percent of the organizations in the samples did not meet the organizational test.

In 2017, TAS again reviewed a representative sample of corporations in the same 20 states, which allowed us to compare the results with the results of the earlier studies. The 2017 study found that 42 percent did not meet the organizational test.

By 2017, four additional states made articles of incorporation available online at no charge.¹¹ Thus, for the 2017 study, in addition to selecting a valid sample of organizations from the same 20 states that were included in the 2015 and 2016 studies, TAS expanded the sample to include representative cases from these four “new” states. When these states were taken into account, 46 percent of organizations in the sample did not meet the organizational test. We noted that further research is needed to ascertain the reason for the higher rate of erroneous approvals for organizations from the four additional states, compared to the original 20 states.

Even though all the organizations in the samples had received a favorable determination from the IRS granting them tax-exempt status and making contributions to them eligible for a tax deduction by the donor, a significant portion of them did not qualify for IRC § 501(c)(3) status as a matter of law.¹²

RESEARCH QUESTIONS

In 2019, TAS again studied a representative sample of corporations in the same original 20 states that were included in the 2015-2017 studies, which allows us to compare the results with the earlier studies. By 2019, yet another state, California, made articles of incorporation available online at no charge. Thus, for the 2019 study, TAS expanded the sample to include representative cases from five “new” states (the four additional states added in the 2017 study, plus California).

For a representative sample of organizations from states that make articles of incorporation available online at no charge whose Form 1023-EZ was approved, we investigated:

1. How often organizations’ articles of incorporation failed to satisfy the organizational test; and
2. Whether revising Form 1023-EZ to require a short description affected the rate of erroneous approvals.

¹⁰ National Taxpayer Advocate 2015 Annual Report to Congress vol. 2, at 1-31 (*Study of Taxpayers That Obtained Recognition as IRC § 501(c)(3) Organizations on the Basis of Form 1023-EZ*); National Taxpayer Advocate 2016 Annual Report to Congress 254 (Most Serious Problem: *Form 1023-EZ: The IRS’s Reliance on Form 1023-EZ Causes It to Erroneously Grant Internal Revenue Code § 501(c)(3) Status to Unqualified Organizations*); National Taxpayer Advocate 2017 Annual Report to Congress 64-72 (Most Serious Problem: *Exempt Organizations: Form 1023-EZ, Adopted to Reduce Form 1023 Processing Times, Increasingly Results in Tax Exempt Status for Unqualified Organizations, While Form 1023 Processing Times Increase*). Organizations were in the following 20 states: Alaska, Colorado, Florida, Idaho, Indiana, Iowa, Kansas, Kentucky, Maryland, Massachusetts, Michigan, Mississippi, Missouri, New Hampshire, North Carolina, Ohio, Oregon, Rhode Island, South Dakota, and Texas.

¹¹ The additional four states were Arizona, Georgia, Virginia, and Vermont.

¹² As a whole, the results of the 2015-2017 studies are statistically valid at the 95 percent confidence level with a margin of error no greater than +/- five percent. Unless otherwise noted, the 2019 study discussed below is also statistically valid at the 95 percent confidence level with a margin of error no greater than +/- five percent.

METHODOLOGY

The IRS's Tax Exempt and Government Entities (TE/GE) Division releases to the public a data file that includes information for approved Form 1023-EZ applications.¹³ Out of these organizations, TAS Research identified a representative, random sample of 365 organizations from the same 20 states as in the 2015, 2016, and 2017 random samples. The articles of incorporation for 18 organizations in the sample (five percent) were not found on the official site for the state in which, according to the application, the organization was formed. We excluded these organizations from our sample, resulting in a sample size of 347.

In addition to selecting a valid sample of organizations from the same 20 states that were included in all the samples in previous studies, we expanded the sample to include representative cases from five additional jurisdictions that now make articles of incorporation available online at no charge.¹⁴ TAS Research identified a representative, random sample of 135 organizations in the additional five states. The articles of incorporation for seven organizations in the sample (five percent) were not found on the official site for the state in which, according to the application, the organization was formed. Thus, we considered 128 organizations from these additional five states.

Therefore in total we reviewed 475 organizations' articles of incorporation.

Like the results of the 2015-2017 studies, the results of this study are statistically valid at the 95 percent confidence level with a margin of error no greater than +/- five percent.¹⁵

DATA COLLECTION

A team of four reviewers, using training material developed by TE/GE on the legal requirements for exempt status as an IRC § 501(c)(3) organization, completed a data collection instrument (DCI) to capture information about each organization in the sample. The DCI was substantially similar to the one used in the prior TAS studies. The four reviewers, consisting of TAS Senior Tax Analysts and Technical Advisors, were the same reviewers who completed DCIs in the 2017 TAS study.

Answering some DCI questions required a review of the organization's publicly available articles of incorporation.¹⁶ Other DCI questions required a review of the IRS's publicly accessible Tax Exempt Organization Search database.¹⁷ Still other DCI questions required a review of the organization's website

13 The data file is available at <https://www.irs.gov/charities-non-profits/exempt-organizations-form-1023ez-approvals>. The data is based on information provided by applicants on Forms 1023-EZ that were approved by the IRS.

14 The additional five jurisdictions are Arizona, California, Georgia, Virginia, and Vermont (the additional jurisdiction since the 2017 study is California).

15 Study findings can be projected to the population of 27,350 organizations from the original 20 states in our study and to the population of 29,500 organizations in the combined 25 states.

16 As noted above, in states that have adopted the *cy pres* doctrine, state law or court action satisfies the requirement for a dissolution provision where there is no provision in the articles of incorporation. Of the states in our sample, California, Massachusetts, Missouri, Ohio, and Texas have adopted the *cy pres* doctrine. See Rev. Proc. 82-2, 1982-1 C.B. 367 and IRS response to TAS information request (June 19, 2019) providing a job aid used by IRS employees to evaluate Form 1023-EZ applications that are selected for pre-determination review. However, if the articles of incorporation contain a dissolution provision that is defective, state law or court action would not cure the defect. See Elizabeth Ardoin, 2004 EO CPE Text Organizational Test — IRC 501(c)(3) 12, Q.11, <https://www.irs.gov/pub/irs-tege/eotopicd04.pdf>. Thus, the reviewers evaluated dissolution clauses for all organizations in the sample.

17 The Tax Exempt Organization Search (Formerly Select Check) data base, <https://www.irs.gov/charities-non-profits/tax-exempt-organization-search> (Nov. 25, 2019).

(if any). To minimize bias, the case reviewers met each week to discuss the data collection and proper completion of the DCI.

FINDINGS

Almost Half — 46 Percent — of Organizations in the 20-State Sample Failed the Organizational Test Because Their Articles Lacked an Adequate Purpose Clause, Dissolution Clause, or Both

The study found that of the 347 organizations in the 20-state sample, 159, or 46 percent, did not meet the organizational test:

- The articles of incorporation of 60 organizations had a required dissolution clause but lacked an acceptable purpose clause;¹⁸
- The articles of incorporation of 27 organizations had an acceptable purpose clause but lacked a required dissolution clause; and
- The articles of 72 organizations had neither an acceptable purpose clause nor a required dissolution clause.¹⁹

Put another way, the articles of incorporation of 188, or 54 percent, had both an adequate purpose clause and a required dissolution clause and thus met the organizational test. Figure 4.4.1 shows the frequency with which organizations in our 20-state sample met (or did not meet) the organizational test, and the reason the test was not met.

FIGURE 4.4.1, Outcomes of 20-State Sample

20-State Sample	Count	Percent
Unacceptable Purpose Clause, Acceptable Dissolution Clause	60	17%
Acceptable Purpose Clause, Unacceptable Dissolution Clause	27	8%
Neither Acceptable	72	21%
One or Both Unacceptable	159	46%
Both Acceptable	188	54%
Total	347	

When considering the 475 organizations in the expanded 25-state sample, we found that 191, or 40 percent, did not meet the organizational test:

- The articles of incorporation of 66 organizations had a required dissolution clause but lacked an acceptable purpose clause;²⁰

18 Of these 60 organizations, the articles of incorporation of 51 had purpose clauses that were inadequate and nine had no purpose clause at all.

19 Of these 72 organizations, the articles of incorporation of 54 had purpose clauses that were inadequate (including one organization that filed its articles of incorporation after it had already received its favorable determination from the IRS) and 18 had no purpose clause at all.

20 Of these 66 organizations, the articles of incorporation of 55 had purpose clauses that were inadequate and 11 had no purpose clause at all.

- The articles of incorporation of 31 organizations had an acceptable purpose clause but lacked a required dissolution clause; and
- The articles of 94 organizations had neither an acceptable purpose clause nor a dissolution clause.²¹

Stated differently, the articles of incorporation of 284 organizations, or 60 percent, had both an adequate purpose clause and a required dissolution clause and thus met the organizational test. Figure 4.4.2 shows the frequency with which organizations in our expanded sample that included five additional states met (or did not meet) the organizational test, and the reason the test was not met.

FIGURE 4.4.2, Outcomes of 25-State Sample

25-State Sample	Count	Percent
Unacceptable Purpose Clause, Acceptable Dissolution Clause	66	14%
Acceptable Purpose Clause, Unacceptable Dissolution Clause	31	7%
Neither Acceptable	94	20%
One or Both Unacceptable	191	40%
Both Acceptable	284	60%
Total	475	

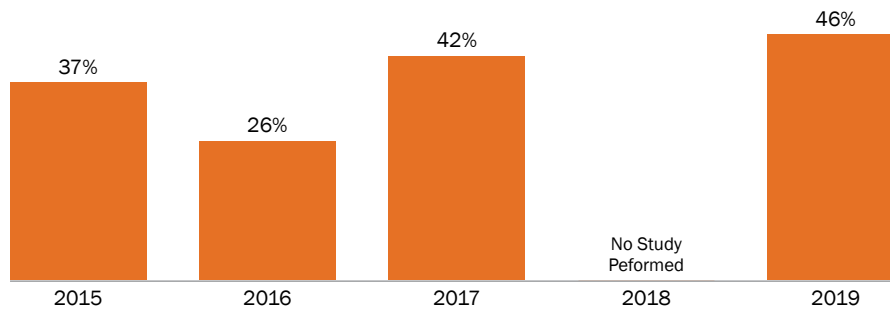
Figure 4.4.3 shows the rate at which Form 1023-EZ applications were erroneously approved over the past years for organizations in the 20 states included in each TAS study.²²

21 Of these 94 organizations, the articles of incorporation of 58 had purpose clauses that were inadequate and 36 had no purpose clause at all.

22 The data reflects the result of the 2015-2017 and 2019 TAS studies. The Form 1023-EZ applications of organizations in the 2015 TAS study were approved between July 1, 2014, and Mar. 27, 2015. The Form 1023-EZ applications of organizations in the 2016 study were approved between July 1, 2015, and June 30, 2016. The Form 1023-EZ applications of organizations in the 2017 study were approved between July 1, 2016, and June 30, 2017. The Form 1023-EZ applications in the 2019 study were approved between July 1, 2018, and June 30, 2019.

FIGURE 4.4.3

Erroneous Approval Rates Found in Review of Form 1023-EZ Applications in 20-State Samples



Including California in the 2019 25-State Sample Reduced the Frequency of Erroneous Approvals to 40 Percent

As noted above, the additional five states in our sample are Arizona, California, Georgia, Virginia, and Vermont. California is the only state that is included in our study for the first time (*i.e.*, we did not find California articles of incorporation available online at the time of our 2015-2017 studies, but they are now available online at no charge). There were 128 organizations from these five states in our sample. Of these 128 organizations, 70 were from California, more than from any other state.²³ Of the 70 California organizations, only four organizations, or six percent, did not meet the organizational test:

- None of the organizations lacked a required dissolution clause in their articles of incorporation;²⁴ and
- The articles of only four organizations lacked an acceptable purpose clause.²⁵

Stated differently, the articles of incorporation of 66 organizations, or 94 percent, had both an adequate purpose clause and a required dissolution clause and thus met the organizational test. Thus, articles of incorporation of California organizations satisfied the organizational test significantly more frequently than those of:

- Organizations in the sample of 20 original states (of which 54 percent satisfied the organizational test); and
- Organizations in the expanded sample of 25 states (of which 60 percent satisfied the organizational test).

23 There were more organizations from California than in any other state, in the 20-state sample and in the expanded sample that included the additional five states. While the 70 California cases were part of a larger sample, percentages reported here for only those 70 cases are statistically valid at the 90 percent confidence level with a margin of error no greater than +/- ten percent.

24 As noted above, California has adopted the doctrine of *cy pres*. Moreover, as discussed below, California provides a template, or form, that organizations may use for their articles of incorporation, and the template contains the required dissolution clause.

25 As discussed below, a California template for articles of incorporation includes a purpose clause. Two of the four organizations whose articles did not contain an adequate purpose clause did not use the template; two others submitted an incomplete template.

The higher rate at which California organizations' articles of incorporation satisfied the organizational test, together with the relatively large number of California organizations in our sample, contributed to lowering the erroneous approval rate for the 25 states in our sample (40 percent), compared to the erroneous approval rate for the 20 original states (46 percent) shown in Figure 4.4.3. We discuss below the reasons why California organizations are more likely to meet the organizational tests.

Defects in Articles of Incorporation Suggest That Organizations Do Not Understand the Requirements for Internal Revenue Code § 501(c)(3) Status

A common defect in organizations' purpose clauses was a lack of specificity such that an exempt purpose could not be identified, or if an exempt purpose was suggested, the organization's activities were not limited to that exempt activity. For example, the following statements comprised the entire purpose clause contained in various organizations' articles of incorporation:

- "Helping people in need;"
- "Non profit youth organization;"
- "Fundraise & boost spirit for high school girls soccer team;"
- "Reduce low self esteem and inspire persons ages 12-18 to have the confidence to celebrate them regardless of any obstacle they may face through events, activities and resources;" and
- "Provide services for ex-offenders: Jobs, housing, counseling to change their attitudes and beliefs about crime, drugs, addressing mental health issues, providing mentoring, connecting them with community resources."²⁶

In other cases, the purpose clause in the articles of incorporation suggested that the organization may *not* have been organized for an exempt purpose (*e.g.*, an organization whose purpose clause in its entirety is "to provide financial assistance to family members with mental health illness").²⁷

A common defect in organizations' dissolution clauses was simply naming a specific recipient to receive the organization's assets upon dissolution. Even if the named recipient is currently an IRC § 501(c)(3) organization, the dissolution clause is inadequate if there is no provision ensuring that the organization's assets will be dedicated to a charitable purpose in the event the named recipient is unwilling to accept the assets, is no longer described in IRC § 501(c)(3), or is no longer in existence.²⁸

Moreover, some organizations were apparently unaware that they are not eligible to file Form 1023-EZ.²⁹ For example, our sample included:

- A church;

26 The instructions to Form 1023-EZ on page 4 give this example of an acceptable purpose clause: "The organization is organized exclusively for charitable, religious, educational, and scientific purposes under section 501(c)(3) of the Internal Revenue Code, or corresponding section of any future federal tax code."

27 As noted above, to qualify for IRC § 501(c)(3) status, no part of the organization's net earnings can inure to the benefit of any private shareholder or individual.

28 The instructions to Form 1023-EZ on page 5 provide this example of an dissolution purpose clause: "Upon the dissolution of this organization, assets shall be distributed for one or more exempt purposes within the meaning of section 501(c)(3) of the Internal Revenue Code, or corresponding section of any future federal tax code, or shall be distributed to the federal government, or to a state or local government, for a public purpose." As the instructions note, "Naming a specific organization or organizations to receive your assets upon dissolution will be acceptable only if your articles state that the specific organization(s) must be exempt under section 501(c)(3) at the time your dissolution takes place and your organizing document provides for distribution for one or more exempt purposes within the meaning of section 501(c)(3) if the specific organization(s) are not exempt."

29 Rev. Proc. 2019-5, § 6.05, 2019-1 I.R.B. 230 (Jan. 2, 2019).

- A university;
- Two limited liability corporations;
- Two organizations that appear to be private operating foundations;
- Three organizations that appear to have applied for reinstatement more than 15 months after their exempt status had been automatically revoked; and
- An organization that appeared to have been previously exempt under a different subsection of IRC § 501(c).

These organizations may qualify for IRC § 501(c)(3) status, but they are not eligible to file Form 1023-EZ; they may request recognition of exempt status by filing Form 1023. Nevertheless, the IRS did not require a full Form 1023 and approved the applications submitted on the truncated Form 1023-EZ.

Using Template Articles of Incorporation Affects Whether Organizations Meet the Organizational Test

Some organizations adopt template articles of incorporation provided by their state of incorporation, but the “form” articles do not always satisfy the organizational test. Georgia is an example of one such state.³⁰ The Georgia template does not contain specific fields for a purpose clause or for a dissolution clause but does provide a field for “Optional Provisions.” Instructions adjacent to the form advise as follows: “Note to nonprofit corporations that will pursue ‘tax exempt’ status: If you intend to apply to the Internal Revenue Service (IRS) for recognition of federal tax-exempt status as a charitable organization under section 501(c)(3) of the Internal Revenue Code, your articles of incorporation must contain certain provisions.” The note is followed by links to IRS websites with the relevant information, but the note does not explain what the required provisions are or clarify that the template does not include the required provisions.

Out of 27 Georgia organizations in our sample, 13 had simply adopted the template form shown on the Georgia Secretary of State website without any including any Optional Provisions, and therefore did not meet the organizational test. State regulators are aware of this problem and note that “[w]hen such organizations’ [“form”] articles of incorporation do not confine the organizations’ activities to charitable purposes, it invites abuse and makes it very difficult for state charity regulators to protect and safeguard what should be charitable assets.”³¹

On the other hand, some states provide template articles of incorporation with purpose and dissolution clauses that appear to comply with the requirements for IRC § 501(c)(3) status. For example, California provides a template for “Articles of Incorporation of a Nonprofit Public Benefit Corporation.”³² Item 4a of the template, captioned “Purpose Statement,” recites that “This corporation is a nonprofit benefit corporation and is not organized for the private gain of any person. It is organized under the Nonprofit

30 For sample articles of incorporation for nonprofits, see Filing Procedure - Corporations, <https://sos.ga.gov/cgi-bin/corpforms.asp>.

31 Letter from Hugh R. Jones, National Association of State Charity Officials (NASCO) President 2007-2008, to Rep. Lynn Jenkins, Chairman, Subcommittee on Oversight, Committee on Ways and Means and Rep. John Lewis, Ranking Member, Subcommittee on Oversight, Committee on Ways Means (Apr. 26, 2018). The letter notes that Hawaii is one state in which nonprofit organizations may use “form” articles of incorporation to simplify the incorporation process, but those “form” articles do not satisfy the organizational test. Because Hawaii does not make articles of incorporation available online, our sample did not include Hawaiian organizations.

32 See California Form ARTS-PB-501(c)(3), <https://www.sos.ca.gov/business-programs/business-entities/forms/>. The form notes, among other things, that “This form is for use by corporations seeking tax-exempt status within the meaning of Internal Revenue Code section 501(c)(3).”

Public Benefit Corporation Law for; [checkbox] public purposes [checkbox] charitable purposes.” The organization is instructed that one or both of the boxes must be checked.

Of the 69 California organizations in our sample, 46, or two-thirds, used the template described above. As long as the organization checked the box to indicate it was organized for charitable purposes, we considered the organization to have an adequate purpose clause.³³ Only two organizations that used the template did not check the “charitable purposes” box.

We note that Item 4b of the California template asks for “the specific purpose of this corporation.” Organizations are instructed to complete Item 4b if “public” purposes is checked in Item 4a, or “if you intend to apply for tax-exempt status in California.”

Generally, the specific descriptions provided in Item 4b consisted of one or two sentences or sentence fragments or the organization’s mission statement. The descriptions generally articulated activities consistent with an IRC § 501(c)(3) charitable purpose, although standing alone they would not qualify as adequate purpose clauses (*i.e.*, if the “charitable” box had not been checked, we would not have considered the purpose clause to be adequate). In this respect, Item 4b of the California template is similar to the field on Form 1023-EZ that solicits a description of the applicant’s activities, as discussed below.

Organizations’ Websites May Shed Additional Light on Their Activities

As noted above, we did not inquire whether the organizations also met the operational test. However, we viewed organizations’ websites where they provided one on the Form 1023-EZ they submitted. The instructions to Form 1023-EZ direct the applicant to provide its current website address. If the organization does not maintain a website it is directed to enter “N/A” (not applicable). Only 134 organizations in our sample provided a website address. Even a cursory review of some organizations’ websites raised doubt about whether the organization operated as an IRC § 501(c)(3) organization, even where the organizational test was met.³⁴

For example, one California organization checked the “charitable” box in Item 4a of the California template and described its specific purpose in Item 4b as “help create freedom for the unbanked, excluded, hopeless, helpless & homeless.” The website it provided on its Form 1023-EZ application, however, invites the visitor to consider that:

Non-Profit organisations simply do not work, because there is no benefit for the donator and contributor other than a thought of “I have helped someone less fortunate than myself” How do you know? Would it not be better IF you could donate and the person or the family you are helping can turn their life around and your help will give you a direct benefit...

The same website also invites the visitor to:

Imagine a new, asset-backed cryptocurrency with its own organic ecosystem of fully owned consumer businesses. One that lets you fulfil [sic] all your travel, cosmetics, education,

³³ Item 5 of the template, captioned Additional Statements, provides in Item 5a that “This corporation is organized and operated exclusively for the purposes set forth in Article 4 hereof within the meaning of Internal Revenue code section 501(c)(3).”

³⁴ IRS reviewers do not routinely review the website the organization provides on Form 1023-EZ. See Internal Revenue Manual (IRM) 7.20.9.4, General Case Processing (Sept. 28, 2019) (requiring review of the website where the organization appears to be an LLC, IRS databases indicate the organization may be formed as a for profit entity, or where the organization used an NTEE code that is invalid or inconsistent with the stated mission or activity).

property, restaurant, and entertainment needs at wholesale prices while rewarding you with more currency to spend. [Ours] is the world's only asset backed cryptocurrency. It already saves our customers over 50%...

As another example, a different organization provided a website on its Form 1023-EZ that notifies the visitor on the first page that “As for me, personally, besides this global Quest, Cause, and Movement, I am running as independent for the U.S. House of Representatives, [District and State] this coming November 2018.”³⁵

Additional Information Added to Form 1023-EZ in 2018 Does Not Appear to Have Affected the Erroneous Approval Rate

At the National Taxpayer Advocate's insistence, Form 1023-EZ was revised, and since January 2018 has contained a field for applicants to “Briefly describe the organization's mission or most significant activities.”³⁶ Thus, all the organizations in our sample filed the revised Form 1023-EZ. The instructions to Form 1023-EZ direct applicants to:

Briefly describe your mission or most significant activities (limit 255 characters). Provide a brief summary of your tax-exempt 501(c)(3) purposes and the activities you engage in to further those purposes (see below for examples and a description of various 501(c)(3) purposes). Don't refer to or repeat purposes in your organizing document or speculate about potential future programs. You should describe either actual or planned mission or activities.

Considering the 20-state samples we evaluated over the years, the erroneous approval rate increased after the Form 1023-EZ was changed to require the short description discussed above, from 42 percent in 2017 to 46 percent in the 2019 study.³⁷ Thus, the additional information did not appear to avert erroneous approvals.³⁸

A possible explanation for this phenomenon — that the IRS has more information yet actually makes erroneous determinations more frequently — could lie in how IRS reviewers (tax examiners) are instructed to evaluate the description. They do not review organizing documents such as articles of incorporation, even when the documents are available online. Thus, they do not know whether the short

35 As noted above, to qualify for IRC § 501(c)(3) status, the organization cannot participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office (IRC § 501(c)(3)).

36 The National Taxpayer Advocate issued a Taxpayer Advocate Directive (TAD) on September 26, 2016, directing the IRS, among other things, to revise Form 1023-EZ to require applicants to submit a brief narrative statement of their actual or planned activities. The IRS acquiesced to that portion of the TAD. The National Taxpayer Advocate has the authority to issue a TAD “to mandate administrative or procedural changes to improve the operation of a functional process or to grant relief to groups of taxpayers (or all taxpayers) when implementation will protect the rights of taxpayers, prevent undue burden, ensure equitable treatment, or provide an essential service to taxpayers” pursuant to Delegation Order 13-31 (formerly DO-250, Rev. 1), reprinted as IRM 1.2.50.4 (Jan. 17, 2001). See also IRM 13.2.1.6, Taxpayer Advocate Directives (July 16, 2009).

37 As discussed above, the relatively low rate of 40 percent we found in our 25-state sample is likely due to the use of template articles of incorporation, especially by organizations in one large state, California.

38 Requiring the additional description also did not appear to assist applicants in formulating acceptable purpose clauses. In our 2015 study, for example, we found that out of 408 organizations in the 20-state sample, 124 organizations, or 30 percent, lacked an adequate purpose clause. National Taxpayer Advocate 2015 Annual Report to Congress vol. 2, at 11 (*Study of Taxpayers That Obtained Recognition as IRC § 501(c)(3) Organizations on the Basis of Form 1023-EZ*). The 2019 study shows that out of 347 organizations in the 20-state sample, 132 organizations, or 38 percent, lacked an adequate purpose clause.

description merely “repeated purposes in the organizing document.” Moreover, the described mission and activities need only be “within the scope of IRC § 501(c)(3)” to be deemed sufficient.³⁹

If the tax examiner finds that the applicant has provided “a potentially non-501(c)(3) mission/activity” or “an incomplete mission/activity,” the tax examiner is required to refer the case to a specialist.⁴⁰ If the specialist then finds that the description is incomplete, the specialist may reject the (incomplete) application or have the case assigned for further review. If the specialist finds “a potentially non-501(c)(3) mission/activity,” he or she will have the case assigned for further review.⁴¹ If the employee to whom the case is assigned finds that there is an “unclear, incomplete, or potentially non-501(c)(3) mission/activity description,” then the employee must “research or ask for information as needed to determine qualification for exemption.”⁴²

TAS is unable to determine whether the applications of specific organizations in our sample had been referred to a specialist or then assigned for further review. However, it appears that further review was warranted in some cases, such as where the descriptions appeared incomplete or were so broad as to be virtually meaningless. Examples of such descriptions, in their entirety, include:

- “Sober living;”
- “Community outreach;”
- “Promoting cultural relationships thru food and activities;”
- “[Name of organization] is a nonprofit dedicated to increasing diversity and breaking down barriers to entry in the blockchain space;” and
- “To provide international medical mission and community outreach services.”

The descriptions provided by some applicants in our sample did not appear to meet even the very broad “within the scope of IRC § 501(c)(3)” standard. Examples in this category include the following descriptions:

- “To stimulate the economies of underresourced urban communities in [City] by providing affordable loans to local businesses offering goods and services directly to those communities;”
- “Build new homes to be sold to low income families;” and
- “The [Foundation’s] purpose is to equip individuals and families with the necessary tools to obtain the highest level of education possible, to live a healthy lifestyle and to accomplish the American dream through home ownership.”

In view of the high rate of erroneous approvals despite the additional information Form 1023-EZ now elicits, it appears that more far-reaching revisions to Form 1023-EZ — or a different standard for evaluating the description — are needed.⁴³

39 IRS reviewers are instructed to “review the activity description to determine if the organization’s mission and activities are within the scope of IRC Section 501(c)(3).” IRM 7.20.9.4 (11), General Case Processing (Sept. 28, 2018).

40 IRM 7.20.9.4.5, Tax Examiner Requests Specialist Involvement (Tax Examiner) (Sept. 28, 2018).

41 IRM 7.20.9.4.5.1, Specialist Involvement (Specialist) (Sept. 28, 2018).

42 IRM 7.20.9.4.6, Pre-determination Review and Tax Examiner Referral Cases (Specialist) (Sept. 28, 2018).

43 The IRS Deputy Commissioner for Services and Enforcement rescinded the portion of the TAD in which the National Taxpayer Advocate ordered the IRS to require Form 1023-EZ applicants to submit their organizing documents (unless the documents are already retrievable from a state online database). Memorandum from the Deputy Commissioner for Services and Enforcement to the National Taxpayer Advocate (Oct. 25, 2016) sustaining in part National Taxpayer Advocate TAD 2016-1 (Oct. 5, 2016).

CONCLUSION

The IRS approves Form 1023-EZ applications submitted by organizations that do not qualify for IRC § 501(c)(3) status at a rate that is unacceptable and is higher now than when the form was introduced. The use of template articles of incorporation is widespread in some jurisdictions. In some states, using the template practically guarantees that the organization will (or will not) meet the organizational test. Even where applicants meet the organizational test, it is sometimes apparent from information on the websites they provide as part of their Form 1023-EZ application that they do not operate for an exempt purpose. The additional information Form 1023-EZ now elicits, a short description of the applicant's mission or activities, does not appear to have reduced the rate at which the IRS erroneously approves applications.

RECOMMENDATIONS

1. Require Form 1023-EZ applicants to submit their organization documents as part of the application and make a determination only after reviewing the organizing documents.
2. Review Form 1023-EZ applicants' websites, if any, before making a determination.
3. Ascertain the frequency with which applicants' descriptions of their mission and activities on Form 1023-EZ result in referrals of the application for further review, and if such further review is infrequent, conduct additional training on procedures for evaluating Form 1023-EZ applications.
4. Revise IRS procedures to require reviewers to determine whether applicants' descriptions of their mission and activities on Form 1023-EZ clearly identify an exempt purpose, rather than requiring a determination of whether the mission or activity is "within the scope" of IRC § 501(c)(3).