

Area of Focus #8 **Because Oversight Is Weak, the Risk of Erroneous Approvals of Form 1023-EZ Applications Continues to Be Great**

TAXPAYER RIGHTS IMPACTED¹

- *The Right to Be Informed*
- *The Right to Quality Service*
- *The Right to Finality*

DISCUSSION

The National Taxpayer Advocate has for many years raised concerns about the length of time it takes the IRS to process Forms 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*.² The IRS's goal has been to process all applications within six months.³ If an application goes unanswered for 270 days (about nine months), taxpayers may request a declaratory judgment as to their status as an organization described in IRC § 501(c)(3).⁴

In 2014, when the Form 1023 processing time was 315 days, the IRS adopted Form 1023-EZ, *Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, to address its Form 1023 inventory backlogs.⁵ Form 1023-EZ consists of checkboxes that allow applicants to attest, rather than require them to demonstrate, that they meet essential requirements for exempt status. By fiscal year (FY) 2016, Form 1023 cycle time had decreased to 96 days.⁶ Form

1 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are also codified in the Internal Revenue Code (IRC). See IRC § 7803(a)(3).

2 National Taxpayer Advocate 2017 Annual Report to Congress 64 (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*); National Taxpayer Advocate 2013 Annual Report to Congress 165 (Most Serious Problem: *Exempt Organizations: The IRS Continues to Struggle with Revocation Processes and Erroneous Revocations of Exempt Status*); 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*); National Taxpayer Advocate 2004 Annual Report to Congress 193, 203 (Most Serious Problem: *Application and Filing Burdens on Small Tax-Exempt Organizations*).

3 Jeff Carlson, *IRS Making Progress in Improving 501(c)(3) Application Process, Says Koskinen*, CCH News (Apr. 8, 2014), reporting on Comm'r Koskinen's testimony before the House Appropriations Committee Subcommittee on Financial Services and General Government on the Fiscal Year (FY) 2015 IRS budget at <http://tst-news.cchgroup.com.php56-7.ord1-1.websitetestlink.com/2014/04/08/irs-making-progress-in-improving-501c3-application-process-says-koskinen/>.

4 IRC § 7428(a)(2).

5 National Taxpayer Advocate FY 2015 Objectives Report to Congress 47-48 (Area of Focus: *Despite Improvements, TAS Remains Concerned About IRS Treatment of Taxpayers Applying for Exempt Status*). Processing time, or cycle time, is a 12-month rolling average of the number of days that elapse from the date the application is submitted through the date it is closed.

6 Tax Exempt and Government Entities (TE/GE) response to TAS information request (Aug. 31, 2017).

1023-EZ cycle time was 13 days, and the average cycle time for all applications processed by the Exempt Organization (EO) function was 54 days.⁷

Cycle times for applications other than Form 1023-EZ are higher now than they were in 2016 and the data available thus far indicates they may continue to rise. For example, average processing time for Form 1023 applications (and other applications other than Form 1023-EZ) was 100 days as of September 25, 2018, but had risen to 160 days as of December 11, 2018.⁸

The IRS did not process applications for exempt status in the 35-day period that began on December 22, 2018, when IRS appropriations lapsed. This interruption lengthened the Form 1023 processing times that were already increasing.⁹

As described below, in January 2018, the IRS revised Form 1023-EZ to elicit additional information from applicants. The average age of open Form 1023-EZ inventory, although rising, has remained relatively small (23 days at the end of September 2018, 36 days by mid-February 2019).¹⁰ Thus, on one hand, soliciting the additional information does not appear to be impeding the IRS from making determinations about Form 1023-EZ applicants within a reasonable amount of time. On the other hand, as discussed below, the IRS is not adequately evaluating the additional information it receives.

The IRS Has Not Changed Its Procedures in Light of Additional Information Form 1023-EZ Elicits Since It Was Revised in 2018

Since Form 1023-EZ was adopted in 2014, the National Taxpayer Advocate has been concerned that it does not elicit enough information to allow the IRS to make an informed determination about whether an organization qualifies for IRC § 501(c)(3) status.¹¹ As discussed below, in 2015, 2016, and 2017, TAS reviewed the articles of incorporation of representative samples of successful Form 1023-EZ applicants

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- 7 TE/GE response to TAS information request (Oct. 20, 2017). Almost all of the Exempt Organization (EO) function's processing work consists of Form 1023 or Form 1023-EZ applications, but EO also processes a relatively small number of applications for exempt status under other subsections of IRC § 501(c), or for other types of determinations. Of 95,529 applications EO received in FY 2018, 87,764, or 92 percent, were Form 1023 or Form 1023-EZ applications. TE/GE, *FY 2017 Accomplishments* 8 (Mar. 2018).
- 8 EO Tax Journal *Email Updates* 2018-188 (Sept. 25, 2018) and 2018-248 (Dec. 26, 2018), reporting remarks of the EO Division Director to members of the TE/GE Exempt Organizations Council. TAS plans to develop more complete cycle time data in this fiscal year.
- 9 EO Tax Journal *Email Updates* 2019-94 (May 13, 2019), reporting remarks of the EO Division Director to members of the TE/GE Exempt Organizations Council, who noted that "current case processing time for 1023 applications is 178 days. For the non-1023 cases it is slightly higher than that and those are running at about 186 days."
- 10 EO Tax Journal *Email Updates* 2019-51 (Mar. 14, 2019), reporting remarks of the EO Division Director to members of the TE/GE Exempt Organizations Council.
- 11 See, e.g., National Taxpayer Advocate FY 2015 Objectives Report to Congress 54-57 (Area of Focus: *Despite Improvements, TAS Remains Concerned About IRS Treatment of Taxpayers Applying for Exempt Status*).

from states whose articles were publicly available.¹² The study findings led the National Taxpayer Advocate to issue a Taxpayer Advocate Directive (TAD), which induced the IRS to revise the form.¹³

TAS reviewed the sampled organizations' articles of incorporation to ascertain whether they contained purpose and dissolution clauses as required by Treasury regulations, thereby conforming with the statutory organizational test for tax exempt status.¹⁴ The studies found that too often—between 26 and 42 percent of the time—the requirements for IRC § 501(c)(3) status were not met and the IRS approval was erroneous.¹⁵ However, Form 1023-EZ applications were approved over 90 percent of the time.¹⁶ The IRS's own data showed that it frequently conferred exempt status on Form 1023-EZ applicants in error.¹⁷

On September 26, 2016, the National Taxpayer Advocate issued a TAD 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, and the IRS acquiesced to that portion of the directive.¹⁸ Since January 2018, Form 1023-EZ has contained a field for the description. The instructions to the form direct applicants to “consider your past, present, and planned activities” and to briefly (in 255 characters or less) “describe your mission or most significant activities.”¹⁹

In light of the frequency with which Form 1023-EZ applications are approved erroneously, we expected that the IRS, armed with more complete information about applicants, would correspond with applicants whose brief narrative statement raised concern. Applicants could revise their organizing documents if needed or otherwise perfect their applications. However, current IRS procedures have not been revised to require applicants to submit their organizing documents or amended organizing

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- 12 National Taxpayer Advocate 2015 Annual Report to Congress vol. 2 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: *Exempt Organizations: 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: *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*).
- 13 The National Taxpayer Advocate has the authority to issue a Taxpayer Advocate Directive (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.” See Delegation Order 13-31 (formerly DO-250, Rev. 1), *reprinted as Internal Revenue Manual (IRM) 1.2.50.4* (Jan. 17, 2001); see also *IRM 13.2.1.6* (July 16, 2009).
- 14 See *Treas. Reg. §§ 1.501(c)(3)-1(b)(1)(i)(a), (b); 1.501(c)(3)-1(b)(4); 1.501(c)(3)-1(b)(2)*.
- 15 See National Taxpayer Advocate 2015 Annual Report to Congress vol. 2 1-31 (*Study of Taxpayers That Obtained Recognition As IRC § 501(c)(3) Organizations on the Basis of Form 1023-EZ*), finding a 37 percent erroneous approval rate; 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*), finding a 26 percent erroneous approval rate; National Taxpayer Advocate 2017 Annual Report to Congress 64-72 (Most Serious Problem: *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*), finding a 42 percent erroneous approval rate.
- 16 See *Form 1023-EZ Update Report 4*, https://www.irs.gov/pub/irs-tege/form_1023ez_update_report_final.pdf, referenced in Tax Exempt and Government Entities FY 2017 Work Plan 2 (Sept. 28, 2016, as amended Mar. 8, 2017), noting a 94 percent approval rate of Form 1023-EZ applications.
- 17 *Id.* at 3-4, noting that “EO has approved 94% of all Form 1023-EZ applications closed to date. Through the predetermination review process [a process in which the IRS requests a few additional pieces of information from an applicant, such as organizing documents], approximately 79% of applications have been approved.”
- 18 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, *Revise Form 1023-EZ to Require Additional Information from Applicants, Require Review of Such Additional Information Before Making a Determination, and Explain Your Conclusions With Respect to Each of 149 Organizations Identified by TAS* (Oct. 5, 2016).
- 19 IRS, *Instructions for Form 1023-EZ 5* (Jan. 2018).

documents.²⁰ Thus, the IRS is not ensuring that organizations take curative steps, even when it identifies a defect in the application on the basis of the additional information the form elicits.²¹

The IRS plans to develop a revised electronic Form 1023, to be released in January 2020, and is including TAS in discussions about the process. While it may be appropriate to shorten Form 1023 as part of this process, TAS will seek to insure that the revised form does not undermine the IRS's oversight role of the tax exempt sector as occurred in 2014 with the introduction of Form 1023-EZ.

EO's Plan to Manage the Risk of Erroneous Approvals by Auditing Exempt Organizations Does Not Appear to Have Been Implemented

When it introduced Form 1023-EZ, the IRS recognized that using the form posed the following risks:

- Decreased IRS involvement in applicant engagement and education;
- Insufficient information on the form for the IRS to make an accurate determination;
- Increased likelihood of fraud;
- Perception that applicants could be treated inconsistently; and
- Possibility that application processing may be inadequate.²²

The IRS planned to mitigate these risks by:

- Providing extensive educational materials and clarifying instructions;
- Implementing the predetermination review process; and
- Implementing the post-determination compliance program.²³

The National Taxpayer Advocate agrees that the IRS should provide educational materials and helpful instructions, but the IRS's own data demonstrates that these measures have not sufficiently mitigated the identified risks. As noted above, the IRS's predetermination reviews show that a significant level of Form 1023-EZ applications are approved erroneously. As discussed below, its post-determination process does not appear to be mitigating the risks created by a lack of up-front oversight.

The IRS has always intended to substitute up-front oversight primarily with post-determination audits.²⁴ In 2016, EO identified for audit a random sample of 1,182 organizations whose Form 1023-EZ applications had been approved and who had been operating for at least a year.²⁵ As of March 29, 2018,

20 IRM 7.20.9.4 (11), *General Case Processing* (Sept. 9, 2018).

21 The IRS is also not denying Form 1023 or Form 1023-EZ applications more frequently. IRC § 6110 requires the IRS to publish final letters that revoke or deny an organization's exempt status, but with taxpayer identifying information deleted. The IRS posts redacted revocation and denial letters at *IRS Written Determinations*, <https://apps.irs.gov/app/picklist/list/writtenDeterminations.html;jsessionid=ae0lcixXzkTYpdDZKWMqaEHPPEljoPrD8KhdUcVM.-?value=&criteria=uilc&submitSearch=Find>. In addition, Tax Analysts, the publisher of Tax Notes, publishes these written determinations in *Tax Notes Today*. We identified 44 denial letters to organizations seeking IRC § 501(c)(3) status issued in calendar year 2017 and 43 in 2018.

22 *Form 1023-EZ Update Report 11*, https://www.irs.gov/pub/irs-tege/form_1023ez_update_report_final.pdf, referenced in Tax Exempt and Government Entities (TE/GE) FY 2017 Work Plan 2 (Sept. 28, 2016, as amended Mar. 8, 2017).

23 *Id.*

24 See, e.g., TE/GE, *Business Performance Review (BPR) First Qtr. FY 2015 30*, Appendix B, TE/GE Risk Register (Feb. 2015), noting that its response to "perceived 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..." included transferring that risk to the Exempt Organization Exam function. The risk would be mitigated in the future by "expanded compliance efforts."

25 *Form 1023-EZ Update Report 10*, https://www.irs.gov/pub/irs-tege/form_1023ez_update_report_final.pdf, referenced in TE/GE FY 2017 Work Plan 6 (Sept. 28, 2016, as amended Mar. 8, 2017), noting that 31 EO employees from the Determinations unit were realigned to the Examinations function.

51 percent of the randomly-selected organizations were noncompliant, or risked noncompliance, in some respect.²⁶

In 2018, EO hired 11 tax examiners to process Form 1023-EZ applications, and 20 EO Examinations employees volunteered for one year to process EO applications rather than conduct audits.²⁷ By 2019, in view of increased Form 1023 processing times, the IRS announced that “we are re-allocating resources basically from examination to help us with the determination inventory.”²⁸ Thus, the backstop to the truncated up-front reviews for Form 1023-EZ will be reduced.

CONCLUSION

The IRS has struggled for years to contain Form 1023 processing times. With Form 1023-EZ, the IRS reduced Form 1023 cycle times—at the cost of exercising actual oversight of the tax-exempt sector—only to see them rise again. Post-determination compliance efforts (*i.e.*, audits) were intended to correct for the lack of up-front oversight; however, the IRS is shifting resources away from these compliance efforts in order to keep up with its increasing cycle times. These developments, coupled with a potentially over-simplified revised Form 1023 application, mean that even more applicants will be recognized as IRC § 501(c)(3) organizations when they do not qualify for that status. Once exempt status is recognized, organizations will operate with a tax subsidy and will be subject to little compliance review by the IRS.

FOCUS FOR FISCAL YEAR 2020

In fiscal year 2020, TAS will:

- Review a representative sample of corporations in states that make articles of incorporation available online whose Form 1023-EZ was approved to determine how often the IRS confers IRC § 501(c)(3) status on organizations that do not qualify for that status;
- Report on Form 1023 and Form 1023-EZ cycle times;
- Report on EO Determinations and Examinations staffing levels;
- Report on post-determination revocations and audit outcomes of successful Form 1023-EZ applicants; and
- Advocate for a revised Form 1023 that is not oversimplified and that, unlike Form 1023-EZ, does not allow applicants to simply attest that they meet essential requirements for IRC § 501(c)(3) status without requiring documentation that they qualify for that status.

26 See TE/GE, *FY 2017 Accomplishments* 4 (Mar. 2018), reporting that 565 audits had closed, only 49 percent with no change. For a description of the type of noncompliance, see TE/GE, BPR Third Qtr. FY 2017 30 (Oct. 2017), reporting that as of Oct. 2017, 486 of these examinations had closed, of which only 250, or 51 percent, closed with no change: 144 organizations were issued advisories; 66 provided amendments to their organizing documents; four provided related returns or delinquent returns; two terminations; and one revocation of exempt status.

27 TE/GE, BPR, Fourth Qtr. FY 2018 7 (undated).

28 EO Tax Journal *Email Update* 2019-51 (Mar. 14, 2019), reporting remarks of the EO Division Director to members of the TE/GE Exempt Organizations Council. But see EO Tax Journal *Email Update* 2019-56 (Mar. 21, 2019) reporting remarks of the EO Examinations Director to members of the TE/GE Exempt Organizations Council, describing plans for April 2019 to hire approximately 50 revenue agents and 14 Tax Compliance Officers for EO Examinations work only, and to continue to hire Examination employees throughout the year.