MSP #19 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

RESPONSIBLE OFFICIAL

Sunita Lough, Commissioner, Tax Exempt and Government Entities Division

TAXPAYER RIGHTS IMPACTED[1]

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

DEFINITION OF PROBLEM

In 2014, the IRS adopted Form 1023-EZ, *Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, which requires applicants to merely attest, by checking boxes on the form, that they meet the requirements for qualification as IRC § 501(c)(3) organizations.[2] Most applications for IRC § 501(c)(3) status are now submitted on Form 1023-EZ and the IRS approves 94 percent of Form 1023-EZ applications.[3]

The IRS erroneously approves Form 1023-EZ applications at an unacceptably high rate:

- According to the IRS's pre-determination reviews of a portion of Form 1023-EZ applicants, 25 percent do not qualify for exempt status because they do not meet the "organizational test;"[4]
- According to a 2015 TAS study of a representative sample of approved Form 1023-EZ applicants in 20 states that make articles of incorporation viewable online at no cost, 37 percent do not meet the organizational test and therefore do not qualify as IRC § 501(c)(3) organizations as a matter of law;[5]

1 *See* Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are now listed in the Internal Revenue Code (IRC). *See* Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).

2 Among other things, organizations eligible to submit Form 1023-EZ must generally have annual gross receipts of less than $50,000 and assets of less than $250,000. *See Form 1023-EZ Eligibility Worksheet*, questions 1-3.

3 Tax Exempt and Government Entities (TE/GE) Fiscal Year (FY) 2016 Third Qtr. Business Performance Review (BPR), at 5 (Sept. 2016) (noting that 58 percent of all applications for IRC § 501(c)(3) status were submitted on Form 1023-EZ).

4 TE/GE response to TAS information request (Oct. 5, 2016). As described below, the "organizational test" generally requires an applicant's organizing document to contain adequate purpose and dissolution clauses. *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).

5 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*). As described below, the "organizational test" generally requires an applicant's organizing document to contain adequate purpose and dissolution clauses. *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).

- According to the IRS's analysis, at least 17 percent of the Form 1023-EZ applicants in the sample TAS analyzed in its 2015 study do not meet the organizational test;[6] and
- According to a 2016 TAS study using similar methodology as the 2015 TAS study, 26 percent of approved Form 1023-EZ applicants do not meet the organizational test.

On October 25, 2016, the IRS Deputy Commissioner for Services and Enforcement sustained the National Taxpayer Advocate's September 26, 2016 Taxpayer Advocate Directive (TAD) which directs the Tax Exempt and Government Entities division (TE/GE) to require Form 1023-EZ applicants to submit a brief narrative statement of their actual or planned activities.[7] The Deputy Commissioner rescinded the portion of the TAD that directs TE/GE to require Form 1023-EZ applicants to submit summary financial information and organizing documents not already available from a State online database.[8]

ANALYSIS OF PROBLEM

Background

An applicant seeking to qualify as an organization described in IRC § 501(c)(3) must demonstrate that it meets an "organizational test" and an "operational test."[9] The "organizational test" requires an applicant's "organizing document" to establish that it is "organized and operated exclusively" for one of eight enumerated exempt purposes.[10] The "operational test" requires the applicant to engage primarily in activities which accomplish one or more of the eight exempt purposes specified in IRC § 501(c)(3).[11] No more than an insubstantial part of its activities can be not in furtherance of an exempt purpose,[12] and the organization must be operated to further public rather than private interests.[13]

In 2014, TE/GE adopted "streamlined" procedures that allowed some organizations whose Form 1023 applications needed further development to provide "assurance of meeting the organizational and operational tests through representational attestations" (as opposed to submitting substantiating

6 TE/GE response to 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). TAD 2016-1 is attached as an appendix to this Most Serious Problem.

7 Memorandum from the Deputy Commissioner for Services and Enforcement to the National Taxpayer Advocate (Oct. 25, 2016).

8 *Id.*

9 Treas. Reg. § 1.501(c)(3)–1(a)(1) (providing that "[i]f an organization fails to meet either the organizational test or the operational test, it is not exempt.").

10 IRC § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(b)(1)(i) (providing "[a]n organization is organized exclusively for one or more exempt purposes only if its articles of organization," among other things, limit the purposes of such organization to one or more exempt purposes); Treas. Reg. § 1.501(c)(3)-1(b)(4) (providing "[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…"). In some states, sometimes referred to as *cy pres* states, a dissolution clause is not required because by operation of state law, 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. *See* Rev. Proc. 82-2, 1982-1 C.B. 367.

11 *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)").

12 *See* Treas. Reg.§ 1.501(c)(3)–1(c)(1) (providing that "[a]n organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose").

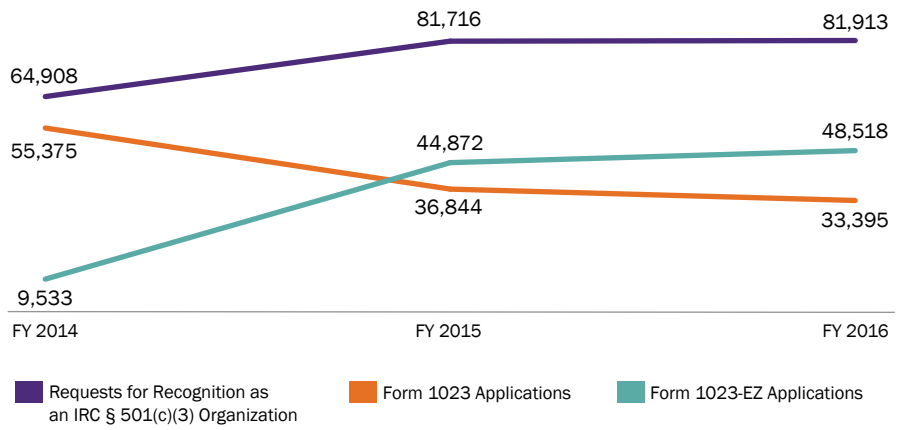
13 Treas. Reg. § 1.501 (c)(3)-1(d)(1)(ii).

documents).[14] In July 2014, TE/GE introduced Form 1023-EZ, which incorporates the "attestation" feature of the streamlined procedures.

Applications for exempt status under IRC § 501(c)(3) immediately increased following introduction of the streamlined procedures and Form 1023-EZ. Figure 1.19.1 shows the total number of applications for IRC § 501(c)(3) status, the number submitted on Form 1023, and the number submitted on Form 1023-EZ.

FIGURE 1.19.1[15]

Requests for Recognition as an IRC § 501(c)(3) Organization, FYs 2014-2016



As Figure 1.19.1 demonstrates, Form 1023-EZ fueled an increase in overall applications for IRC § 501(c)(3) status and has overtaken Form 1023 as the primary vehicle for requesting such status.

Many Form 1023-EZ Applicants Are Recognized As IRC § 501(c)(3) Organizations Even Though They Do Not Qualify for That Status

TE/GE subjects a sample of Form 1023-EZ filers to pre-determination review, rather than relying solely on their attestations. The 2,405 pre-determination reviews TE/GE had completed as of August 19, 2016, showed that Form 1023-EZ applicants did not meet the organizational test 25 percent of the time, despite their attestations to the contrary.[16] Yet TE/GE approves Form 1023-EZ applications 94 percent of the time.[17]

A 2015 TAS study of a representative sample of 408 corporations in 20 states that make articles of incorporation viewable online at no cost whose Form 1023-EZ was approved found that 149 of the

14 *See* TE/GE-07-0214-02, *Streamlined Processing Guidelines for All Cases* (Feb. 28, 2014).

15 TE/GE response to TAS fact check (Nov. 28, 2016); TE/GE FY 2016 BPR First Qtr. Business Performance Review (BPR) at 4, 18 (Mar. 2016); TE/GE response to TAS information request (Nov. 14, 2016).

16 TE/GE response to TAS information request (Oct. 5, 2016).

17 TE/GE FY 2016 Third Qtr. BPR at 5 (Sept. 2016).

The 2016 TAS study showed that of 323 organizations in the representative sample, 85 organizations, or 26 percent, do not meet the organizational test and therefore do not qualify as IRC § 501(c)(3) organizations as a matter of law.

organizations in the sample (37 percent) did not satisfy the organizational test.[18] Prior to the release of the report, TAS shared with TE/GE the Employee Identification Numbers (EINs) of all 149 of these organizations and TE/GE advised TAS it did not agree with all of TAS's conclusions.[19] However, TE/GE refused to provide a list of organizations whose organizing documents, according to its analysis, were sufficient.[20] The National Taxpayer Advocate's September 26, 2016, Taxpayer Advocate Directive directed the IRS to share its list with TAS, and TE/GE complied with that directive on October 5, 2016.[21]

According to TE/GE's analysis of the 149 organizations, documents for 13 were no longer available online, and one organization was selected for pre-determination review.[22] Of the remaining organizations, TE/GE concluded that "only" 70 had failed to meet the organizational test.[23] Thus, according to TE/GE's analysis (and assuming that all 14 organizations TE/GE did not review met the organizational test), there is an "organizational test non-compliance rate" of 17 percent.[24]

In 2016, TAS conducted a research study using methodology similar to that used for the 2015, study. TE/GE provided TAS Research a data file with the names, EINs, state of incorporation, ruling date, and addresses of all corporations whose Form 1023-EZ applications were approved from July 1, 2015, through June 30, 2016.[25] From the data file, TAS Research identified a representative random sample of 323 organizations from the 20 states that make articles of incorporation viewable online at no cost.[26] TAS evaluated the organizations in the sample using the same data collection instrument that was used for the 2015 TAS study. The results of the study are statistically valid at the 95 percent confidence level with a margin of error no greater than +/-5 percent.[27] The 2016 TAS study showed that of 323 organizations

18 National Taxpayer Advocate 2015 Annual Report to Congress vol. 2, 13 (*Study of Taxpayers that Obtained Recognition as IRC § 501(c)(3) Organizations on the Basis of Form 1023-EZ*).

19 TE/GE response to TAS information request (July 12, 2016).

20 Email from Director, Exempt Organizations – Rulings & Agreements (Aug. 4, 2016), on file with TAS.

21 TE/GE response to 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).

22 As of Oct. 11, 2016, TAS found all 13 organizations' documents online for their respective states. TE/GE's list notes, with respect to one organization "Selected for pre-determination review. Signed attestation stating they amended." As of Nov. 2, 2016, we were unable to find any record of any amendment to that organization's articles of incorporation.

23 TE/GE response to 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).

24 TE/GE response to TAS fact check (Nov. 28, 2016). Out of a sample size of 408 approved organizations, a finding that 70 did not meet the organizational test represents an error rate of 17 percent. To the extent the organizations TE/GE did not review also did not meet the organizational test, the error rate would be greater. Moreover, TAS does not entirely accept TE/GE's analysis. TAS would concede that the organizing documents of 13 of the 149 corporations could reasonably be construed as meeting the organizational test, but adheres to its conclusion that the other 136 organizations did not meet the organizational test. Out of a sample of 408, a finding that 136 organizations did not meet the organizational test represents an erroneous approval rate of 33 percent.

25 TE/GE response to TAS information request (Sept. 23, 2016). There were 38,196 separate organizations in this file. Of these organizations, 16,295, or approximately 43 percent, were incorporated in the 20 states in which the Secretary of State maintains a website that permitted TAS to view legible copies of corporations' articles of incorporation at no charge.

26 TAS initially identified 330 organizations for further analysis, but articles of incorporation for seven organizations could not be located on the official site for the state in which, according to TE/GE, the organization was formed. These organizations were thus excluded, resulting in a sample size of 323.

27 Study findings can be projected to the population of 16,295 organizations from states in our study.

in the representative sample, 85 organizations, or 26 percent, do not meet the organizational test and therefore do not qualify as IRC § 501(c)(3) organizations as a matter of law. Moreover, in the representative sample of 323 organizations, the articles of incorporation of 12, or four percent, showed that two were limited liability companies, two were churches, seven were schools, colleges or universities or supporting organizations, and one was a private operating foundation. These organizations are never eligible to file Form 1023-EZ, yet they possess a determination letter from the IRS and are holding themselves out as tax exempt.[28]

Post-Determination Audits Are Inadequate Substitutes for Pre-Determination Oversight

TE/GE estimates that it takes an average of 17 hours to conduct a post-determination audit of an organization that filed Form 1023-EZ.[29] It takes an average of five hours to conduct a pre-determination review of a Form 1023-EZ application.[30] Thus, TE/GE could carry out roughly three pre-determination reviews for every post-determination audit. Because pre-determination reviews are generally carried out by higher-graded employees than those who perform audits, audits do not necessarily cost three times more than pre-determination reviews. Moreover, pre-determination reviews could avert the expenses of administrative appeals and litigation stemming from a post-determination audit that culminates in a proposed revocation of exempt status.[31] In any event, by identifying an organization's non-qualification earlier in the process, while the IRS still has leverage and the stakes for the organization are lower, an organization may self-correct, thus averting noncompliance. The cost of noncompliance includes unreported taxable income and claimed deductions for charitable contributions that are later determined to be impermissible.[32] Additional compliance costs include the erosion of taxpayer trust, consumer abuse, and the heightened potential for fraud.

Form 1023-EZ Burdens Potential Donors and State Charity Officials, Who Can No Longer Rely on the IRS's Determinations

Some state charity officials warn potential donors that organizations whose exempt status was obtained by filing Form 1023-EZ require more thorough review to assess whether they are indeed IRC § 501(c)(3) organizations, and some institutional grantors simply treat those organizations as ineligible to receive

28 *See Form 1023-EZ Eligibility Worksheet*, questions 7, 10, 11, 21, and 25. Organizations that do not meet the Form 1023-EZ eligibility requirements may qualify as IRC § 501(c)(3) organizations, but they must apply for recognition using a full Form 1023.

29 TE/GE response to TAS information request (July 12, 2016). These correspondence examinations are conducted primarily by Tax Compliance Officers in the EO Compliance Area. It appears that employees who conduct these audits would normally be graded as GS-9 or lower. *See* Internal Revenue Manual 4.75.27.1, *Overview* (June 1, 2010).

30 *Id*. As TE/GE notes, "[t]hese determinations are conducted by Revenue Agents in EO Determinations that are generally Grade 11 or 12 employees. This estimate only includes time directly attributable to the case by the Revenue Agent. It does not include other processing time, such as time required by clerical staff to establish the case, assign the case to the group, close the case from the system, issue final letters, backend scan paper documents into the system, manage paper files, etc. It also does not include managerial time to assign the case to the agent, review letters, and review cases for closure; nor does it include potential time charged by Quality Assurance personnel for quality review."

31 *See* Rev. Proc. 2016-5, § 12, 2016-1 I.R.B. 188 (providing for revocation (which may be retroactive) or modification of a determination letter recognizing exemption, and affording the same procedures for appealing such revocation or modification as those applicable to denials of an initial application for exempt status); IRC § 7428 (providing for review by the Tax Court, the United States Court of Federal Claims, or the district court of the United States for the District of Columbia of the IRS's determination with respect to the initial or continuing qualification or classification of an organization under IRC § 501(c)(3)).

32 Organizations exempt from tax under IRC § 501(c)(3) are generally not required to pay tax on their related income and may receive tax deductible contributions. *See* IRC §§ 501 and 170(c)(2). An organization determined to not have been tax exempt would be treated as a taxable entity required to report and pay tax on income (whether related to the erstwhile exempt purpose or not).

grants.[33] At least one state plans to collect data about how often an IRS determination letter granting IRC § 501(c)(3) status on the basis of a Form 1023-EZ application is insufficient for state registration purposes.[34] Anecdotal evidences suggests the frequency may be as high as 25 percent of the time in that state.[35]

CONCLUSION

Experience with Form 1023-EZ shows that a significant portion of approved Form 1023-EZ applicants do not qualify for IRC § 501(c)(3) status as a matter of law. In spite of this evidence, TE/GE has continued to rely on Form 1023-EZ and has chosen to substitute time-consuming audits for pre-determination oversight. Moreover, by relinquishing its upfront leverage for achieving compliance via the determination letter process, the IRS has simply shifted the burden of consumer protection and verification downstream to states and donors. This has opened up a gap in which taxpayers and consumers are harmed.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that:

1. In addition to revising Form 1023-EZ to require applicants to provide a brief narrative statement of their actual or planned activities, as directed by the National Taxpayer Advocate's sustained TAD, revise Form 1023-EZ to:
    a. Require applicants, other than corporations in states that make articles of incorporation publicly available online at no cost, to submit their organizing documents; and
    b. Require applicants to submit summary financial information such as past and projected revenues and expenses.
2. Make a determination about qualification as an IRC § 501(c)(3) organization only after reviewing an applicant's narrative statement of actual or planned activities, organizing documents, and summary financial information.
3. Where there is a deficiency in an organizing document, require an applicant to submit a copy of an amendment to its organizing document that corrects the deficiency and has been approved by the state, even where the documents are available online at no cost, before conferring exempt status.

33 Notes of TAS interview of the President of the National Association of State Charities Officials (NASCO) (Aug. 25, 2015), on file with TAS.

34 Notes of TAS interview of Assistant Director, Charitable Trusts Unit, New Hampshire Dept. of Attorney General (Aug. 10, 2016), on file with TAS.

35 *Id*.

APPENDIX 1, TAXPAYER ADVOCATE DIRECTIVE FROM NINA E. OLSON, NATIONAL TAXPAYER ADVOCATE

TAXPAYER ADVOCATE SERVICE
YOUR VOICE AT THE IRS

THE OFFICE OF THE TAXPAYER ADVOCATE OPERATES INDEPENDENTLY OF ANY OTHER IRS OFFICE AND REPORTS DIRECTLY TO CONGRESS THROUGH THE NATIONAL TAXPAYER ADVOCATE

September 26, 2016

Response Due: December 28, 2016
Completed By: December 28, 2016

MEMORANDUM FOR SUNITA LOUGH, COMMISSIONER,
TAX EXEMPT AND GOVERNMENT ENTITIES

FROM: Nina E. Olson
National Taxpayer Advocate

SUBJECT: Taxpayer Advocate Directive **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*

TAXPAYER ADVOCATE DIRECTIVE

Delegation Order No. 13-3 grants the National Taxpayer Advocate the authority to issue a Taxpayer Advocate Directive (TAD). A TAD may be issued to (1) mandate administrative or procedural changes to improve the operation of a functional process, or (2) grant relief to groups of taxpayers (or all taxpayers) when its implementation will protect the rights of taxpayers, prevent undue burden, ensure equitable treatment, or provide an essential service to taxpayers.[1]

[1] Pursuant to Delegation Order No. 13-3, 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." Internal Revenue Manual (IRM) 1.2.50.4, Delegation Order 13-3 (formerly DO-250, Rev. 1), *Authority to Issue Taxpayer Advocate Directives* (Jan. 17, 2001). *See also* IRM 13.2.1.6, *Taxpayer Advocate Directives* (July 16, 2009).

Internal Revenue Manual (IRM) 13.2.1.6.1 (July 16, 2009) provides that in advance of issuing a TAD, the National Taxpayer Advocate attempts to work with and communicate with the owners of the process in order to correct the problem. I included the issue of erroneous approvals of Form 1023-EZ applications as a Most Serious Problem in my most recent Annual Report to Congress, and supported my concerns with the findings of a TAS research study.[2] As described in my Fiscal Year 2017 Annual Report to Congress, I attempted to resolve this issue, and TE/GE rejected my recommendation that it take corrective measures.[3] I noted that I would continue to advocate for taxpayers by issuing this TAD.[4] TE/GE's responses to my recommendations, included in Volume 2 of my Fiscal Year 2017 Annual Report to Congress, show the IRS's continuing refusal to take corrective measures.[5] These reports serve as a formal memorandum issued to the responsible operating area within the meaning of IRM 13.2.1.6.1.2 (July 16, 2009). Therefore, all procedural requirements for issuing this TAD have been satisfied.[6]

I now direct you to take the following actions with respect to Form 1023-EZ:

1. Revise Form 1023-EZ to require applicants to submit:
   a. A brief narrative statement of their actual or planned activities;
   b. Summary financial information such as past and projected revenues and expenses; and
   c. Their organizing documents (unless the documents are already retrievable from a State online database); and
2. Change your procedures to require review of these materials prior to making a determination.

Prior to the release of my 2016 Annual Report to Congress, TAS shared with you the EINs of 149 organizations whose articles of incorporation were insufficient for

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[2] National Taxpayer Advocate 2015 Annual Report to Congress 36-44 (Most Serious Problem: Form 1023-EZ: Recognition as a Tax-Exempt Organization is Now Virtually Automatic for Most Applicants, Which Invites Noncompliance, Diverts Tax Dollars and Taxpayer Donations, and Harms Organizations Later Determined to be Taxable); vol. 2, 1-32 (Research Study: Study of Taxpayers That Obtained Recognition as IRC § 501(c)(3) Organizations on the Basis of Form 1023-EZ), attached.

[3] National Taxpayer Advocate Fiscal Year 2017 Objectives Report to Congress 181-183 (Area of Focus: *The IRS Is Aware That a Significant Proportion of Form 1023-EZ Applications It Approves Are Submitted by Organizations That Do Not Meet the Legal Requirements for IRC § 501(c)(3) Status, But It Has Not Acted to Correct Known Errors and Has Not Revised the Form to Prevent These Erroneous Approvals*), attached.

[4] National Taxpayer Advocate Fiscal Year 2017 Objectives Report to Congress 183 (Area of Focus: *The IRS Is Aware That a Significant Proportion of Form 1023-EZ Applications It Approves Are Submitted by Organizations That Do Not Meet the Legal Requirements for IRC § 501(c)(3) Status, But It Has Not Acted to Correct Known Errors and Has Not Revised the Form to Prevent These Erroneous Approvals)*, attached.

[5] TE/GE response to the National Taxpayer Advocate 2015 Annual Report to Congress, reported in National Taxpayer Advocate Fiscal Year 2017 Objectives Report to Congress vol. 2, 11-16 (Aug. 24, 2016).

[6] IRM 13.2.1.6.2(1), *TAD Appeal Process* (July 16, 2009).

qualification as an IRC § 501(c)(3) organization. You indicated that you did not agree with TAS's conclusions in all cases. Therefore, in addition to the above actions, I also direct you to:

3. Provide TAS the Employer Identification Numbers (EINS) for the entities whose organizing documents you agree are insufficient for qualification as an IRC § 501(c)(3) organization; and
4. Provide TAS the EINs for the entities whose organizing documents you believe are sufficient for qualification as an IRC § 501(c)(3) organization and explain your conclusion with respect to each of these entities.

Please provide a written response to this TAD on or before **December 28, 2016**, or elevate this TAD to the Commissioner of Internal Revenue within ten (10) calendar days of the date on this TAD. If you are complying with this TAD, the actions above must be completed no later than **December 28, 2016.**

I. Issues

The IRS adopted Form 1023-EZ, *Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code* in July of 2014. Because the form does not elicit enough information from applicants to allow the IRS to make a determination as to whether the organization qualifies under IRC § 501(c)(3) as an organization exempt from taxation under IRC § 501(a), TE/GE erroneously grants exempt status at an unacceptably high rate.

II. Procedural History

I have voiced concerns about the adoption of Form 1023-EZ since it was proposed in 2014.[7] My concern was that the IRS, by adopting the form, would essentially abdicate its responsibility to make determinations as to whether an organization meets the qualifications under IRC § 501(c)(3) for tax-exempt status. Subsequent events showed my concern was justified.

According to the applicable statutory framework, an applicant seeking to qualify as an organization described in IRC § 501(c)(3) must demonstrate that it meets an "organizational test" and an "operational test."[8] The "organizational test" requires an applicant's organizing document to establish that it is "organized and operated exclusively" for one of eight enumerated exempt purposes.[9] The

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[7] *See* National Taxpayer Advocate Fiscal Year (FY) 2015 Objectives Report to Congress 54-7.
[8] Treas. Reg. § 1.501(c)(3)–1(a)(1) (providing that "[i]f an organization fails to meet either the organizational test or the operational test, it is not exempt.").
[9] IRC § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(b)(1)(i) (providing "[a]n organization is organized exclusively for one or more exempt purposes only if its articles of organization," among other things, limit the purposes of such organization to one or more exempt purposes); Treas. Reg. § 1.501(c)(3)-1(b)(4) (providing "[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

"operational test" requires the applicant to engage primarily in activities which accomplish one or more of the eight exempt purposes specified in IRC § 501(c)(3).[10] No more than an insubstantial part of its activities can be not in furtherance of an exempt purpose,[11] and the organization must be operated to further public rather than private interests.[12]

TE/GE has known since it introduced Form 1023-EZ that its reliance on the form led it to approve applications by organizations that did not meet the legal requirements to be considered an IRC § 501(c)(3) organization. This is because Form 1023-EZ applications that do not receive pre-determination review are approved 95 percent of the time, but applications that are subject to slightly more scrutiny are approved only 77 percent of the time. When an application is rejected after being subjected to pre-determination review, it is often because the organization does not or cannot respond to basic inquiries from the IRS about its activities.

TAS provided TE/GE with further evidence of the unreliability of Form 1023-EZ. In 2015, TAS analyzed the organizing documents of a representative sample of corporations in 20 states that make articles of incorporation viewable online at no cost whose Form 1023-EZ was approved. The study concluded that 149 out of 408 organizations, or 37 percent, did not satisfy the organizational test and therefore were not, as a matter of law, IRC § 501(c)(3) organizations.

TAS shared the EINs of the 149 organizations with the Exempt Organizations (EO) function of TE/GE and requested that EO assist these organizations by reviewing their organizing documents and requiring them to correct any deficiencies. EO informed TAS it does not agree that all 149 applications were erroneously approved, but refused to explain its conclusions about specific organizations' applications with TAS. EO refused to contact even those organizations it acknowledges do not meet the organizational test, a legal requirement for qualifying as an IRC § 501(c)(3) organization, and whose applications were indeed approved in error. Instead, EO referred all 149 organizations to EO Examination, which may or may not result in audits.[13]

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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…"). In some states, sometimes referred to as *cy pres* states, a dissolution clause is not required because by operation of state law, 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. *See* Rev. Proc. 82-2, 1982-1 C.B. 367.

[10] *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)."

[11] *See* Treas. Reg.§ 1.501(c)(3)-1(c)(1), providing that "[a]n organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose."

[12] Treas. Reg. § 1.501 (c)(3)-1(d)(1)(ii).

[13] As EO informed TAS, "we did our own review of the 149 organizations and agreed that 59 of those failed the purpose test requirement but only 15 failed the dissolution requirements (note: some of those 15 may have also failed the purpose test); however, just that circumstance alone

TAS also recommended that TE/GE revise Form 1023-EZ to avert future erroneous approvals. The IRS has refused to adjust Form 1023-EZ to solicit information from applicants that would allow it to truly make a determination as to whether they qualify for status as an IRC § 501(c)(3)organization.

III. Analysis

In view of EO's indifference to the TAS research study findings, it appears that EO has effectively written the organizational test out of existence. By improperly granting an organization IRC § 501(c)(3) status when it does not meet the legal requirements, the IRS burdens all taxpayers. Approved organizations do not report and pay tax on income that should be subject to tax, and donors claim deductions for contributions that should not be deductible.

The cursory review afforded by Form 1023-EZ invites noncompliance and manipulation. Here is an example of the relevant portion of the articles of incorporation of one corporation whose Form 1023-EZ was approved:

My father [named individual], sufferred [sic] a spinal cord injury in February 2013, which left him a quadriplegic [sic]. His physicians and physical therapists say he is capable of recovering and walking again but his insurance ([name of State] Medicaid) will not cover the expense, so we are hosting fundraisers/benefits to try to raise the money on our own to pay for his therapy out of pocket.[14]

This organization's articles of incorporation, which do not identify any exempt purpose, do not meet the organizational test. Moreover, the articles appear to prevent the organization from operating to further public rather than private interests - they effectively prevent it from meeting the *operational* test. A simple review of this corporation's articles of incorporation would presumably have led the IRS to question whether the organization truly qualifies for tax-exempt status under IRC § 501(c)(3). Instead, by exempting this organization from paying taxes and allowing deductible contributions to it, the IRS failed to apply the law and failed to protect the interests of all taxpayers.

Form 1023-EZ applicants are also harmed because they are deprived of an essential service - effective review of their request for tax-exempt status under

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wouldn't likely necessitate subsequent revocation by Exam. In addition, we explained our risk mitigation efforts via the pre- and post-determination process (PDC) of the EZ to identify on-going compliance issues with the form. The listing of 149 organizations was turned over to EO Examination as a TAS referral. The organizations will be considered for audit under the established examination referral procedures." Email from Director, EO – Rulings & Agreements Executive Lead (Aug. 4, 2016), on file with TAS.

[14] This is the entire text that appears as the "purposes/nature of the business" in the articles of incorporation of an organization included in the TAS study described above. As of July 14, 2016, this corporation was still listed on the IRS's publicly accessible Select Check database as one to which tax deductible contributions may be made.

IRC § 501(c)(3). Defects in organizations' procedures or practices that come to light in a subsequent audit may trigger revocation of tax-exempt status (which may be retroactive). This outcome could be avoided by advising an applicant from the outset when a proposed organizational structure does not meet the organizational test and may even prevent the organization from meeting the organizational test.

Moreover, the IRS has simply shifted the burden of consumer protection and verification downstream to states and donors. Some state charity officials now warn potential donors that organizations whose exempt status was obtained on the basis of Form 1023-EZ require more thorough review to ascertain whether they are indeed IRC § 501(c)(3) organizations, and some institutional grantors simply treat those organizations as ineligible to receive grants.[15]

The harm caused by lack of meaningful review is far from abstract. Most applications for tax-exempt status under IRC § 501(c)(3) are now made using Form 1023-EZ, and as noted above, the IRS approves 95 percent of Form 1023-EZ applications.

IV. Requested Actions

Because the IRS has refused to revise Form 1023-EZ or to assist taxpayers whose Form 1023-EZ was erroneously approved, I am issuing this TAD to protect the rights of taxpayers and prevent undue burden. In light of the significant harm taxpayers are suffering as a result of the IRS's failure to act, I direct you to take the following actions:

I now direct you to take the following actions with respect to Form 1023-EZ:

1. Revise Form 1023-EZ to require applicants to submit:
   a. A brief narrative statement of their actual or planned activities;
   b. Summary financial information such as past and projected revenues and expenses; and
   c. Their organizing documents (unless the documents are already retrievable from a State online database); and

2. Change your procedures to require review of these materials prior to making a determination.

In addition, with respect to the 149 organizations whose EINs TAS shared with you, I direct you to:

[15] Notes of TAS interview of the President of the National Association of State Charities Officials (NASCO) (Aug. 25, 2015) on file with TAS.

3. Provide TAS the EINS for the entities whose organizing documents you agree are insufficient for qualification as an IRC § 501(c)(3) organization; and
4. Provide TAS the EINs for the entities whose organizing documents you believe are sufficient for qualification as an IRC § 501(c)(3) organization and explain your conclusion with respect to each of these entities.

Please provide a written response to this TAD on or before **December 28, 2016**, or elevate this TAD to the Commissioner of Internal Revenue within ten (10) calendar days of the date on this TAD. If you are complying with this TAD, the actions above must be completed no later than **December 28, 2016.** Please send any response or questions to me, with a copy to TAS Attorney Advisor Jill MacNabb.

Attachments

(1) National Taxpayer Advocate 2015 Annual Report to Congress 36-44 (Most Serious Problem: *Form 1023-EZ: Recognition as a Tax-Exempt Organization is Now Virtually Automatic for Most Applicants, Which Invites Noncompliance, Diverts Tax Dollars and Taxpayer Donations, and Harms Organizations Later Determined to be Taxable.*
(2) National Taxpayer Advocate 2015 Annual Report to Congress vol. 2, 1-32 (Research Study: *Study of Taxpayers That Obtained Recognition as IRC § 501(c)(3) Organizations on the Basis of Form 1023-EZ*).
(3) National Taxpayer Advocate Fiscal Year 2017 Objectives Report to Congress 181-183 (Area of Focus: *The IRS Is Aware That a Significant Proportion of Form 1023-EZ Applications It Approves Are Submitted by Organizations That Do Not Meet the Legal Requirements for IRC § 501(c)(3) Status, But It Has Not Acted to Correct Known Errors and Has Not Revised the Form to Prevent These Erroneous Approvals*).
(4) TE/GE response to the National Taxpayer Advocate 2015 Annual Report to Congress, reported in National Taxpayer Advocate Fiscal Year 2017 Objectives Report to Congress vol. 2, 11-16 (Aug. 24, 2016).

cc: John A. Koskinen, Commissioner of Internal Revenue
John M. Dalrymple, Deputy Commissioner, Services and Enforcement