

AREA OF FOCUS #14 **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**

TAXPAYER RIGHTS IMPACTED¹

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

IRS Form 1023-EZ, *Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, introduced in July 2014, requires applicants merely to attest, rather than demonstrate, that they meet fundamental aspects of qualification as an exempt entity. Because Form 1023-EZ does not solicit any narrative of the organization's activities, financial data, substantiating documents, or explanatory material, the National Taxpayer Advocate believes the form is insufficient to allow the IRS to make a determination as to an applicant's exempt status. Because Internal Revenue Code (IRC) § 501(c)(3) organizations are generally not required to pay tax on their related income and may receive tax deductible contributions, erroneously conferring IRC § 501(c)(3) status on ineligible entities contributes to the tax gap.² The IRS has announced from the outset its intention to address possible noncompliance through post-determination audits.³ This approach is a departure from principles of sound tax administration. No one would suggest the IRS stop preventing questionable Earned Income Tax Credit (EITC) refunds from being paid and instead rely solely on post-refund EITC audits to drive compliance.

As reported in the National Taxpayer Advocate's 2015 Annual Report to Congress, TAS undertook a study 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 by the IRS.⁴ TAS's analysis showed that the articles of incorporation for 37 percent of the organizations in the sample did not satisfy the organizational test, a legal requirement for exempt status as an IRC § 501(c)(3) organization.⁵ We recommended that the IRS revise Form 1023-EZ.

1 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR that was adopted by the IRS 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 See IRC §§ 501 and 170(c)(2).

3 Tax Exempt and Government Entities (TE/GE) Business Performance Review (BPR) First Qtr 2015 Appx. B, TE/GE Risk Register (Feb. 2015) (noting that "[p]erceived inadequate oversight of the tax exempt sector as we undertake strategic shifts in how we conduct the up-front review of applications for tax-exempt status..." will be mitigated by "[e]xpanded compliance efforts.").

4 National Taxpayer Advocate 2015 Annual Report to Congress vol. 2, 1-31 (Research Study: *Study of Taxpayers that Obtained Recognition as IRC § 501(c)(3) Organizations on the Basis of Form 1023-EZ*).

5 To satisfy the organizational test, an applicant's organizing document must contain an adequate purpose and, in general, an adequate dissolution clause. See Treas. Reg. §§ 1.501(c)(3)-1(b)(1)(i)(a), (b); 1.501(c)(3)-1(b)(4). "Articles of organization" includes "the trust instrument, the corporate charter, the articles of association, or any other written instrument by which an organization is created." Treas. Reg. § 1.501(c)(3)-1(b)(2). In some states, known as *cy pres* states, a nonprofit corporation's articles need not include a specific dissolution provision 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 Treas. Reg. § 1.501(c)(3)-1(b)(4).

On December 21, 2015, TAS provided Tax Exempt and Government Entities (TE/GE) with a list of 149 organizations in the TAS study whose Form 1023-EZ applications were approved even though the organizations do not qualify as IRC § 501(c)(3) organizations because their articles of incorporation lack an adequate purpose clause or required dissolution clause (or both). We recommended that TE/GE advise the organizations on the list of the deficiencies in their articles and require them to demonstrate (not simply attest) that they amended their articles to comply with the requirements for qualification as IRC § 501(c)(3) organizations.

When TAS followed up with the Exempt Organizations (EO) function in February 2016 by asking how many organizations on the list had been contacted and how many had responded, the Director of Rulings and Agreements replied “the applicable procedures do not provide for contacting these taxpayers to request books & records in this context.”⁶ In a telephone conversation, the Director explained his view that such contact might constitute an audit. When TAS then inquired of the Acting Director, TE/GE EO, whether the 149 organizations would be included in its Form 1023-EZ post-determination audit program, the response was:

The selection of cases for the 1023-EZ post-determination compliance program in EO exam is based on a statistical sample. So if any of those organizations are selected as part of the sample, then they will be examined. We cannot just pull those cases into the sample, as that would invalidate the sample. To select a case for examination, we have to follow very specific examination procedures. These procedures provide internal controls on the selection of cases for examination to ensure that the returns selected for examination follow the examination strategy and are selected in a fair and unbiased manner. Currently, cases are selected for examination using three different methods, statistical sample, the 990 model queries, and referrals. Exam accepts both internal and external referrals. If you would like to submit a referral for these organizations, we would provide those referrals to our Referral Classification Unit for evaluation. I have attached the Form 5666 for your convenience.⁷

TAS then suggested that EO simply conduct compliance checks on the 149 organizations, which would not amount to an audit.⁸ It remains to be seen whether EO will accept this suggestion.

As of May 27, 2016, all but seven of the 149 organizations continued to be listed on Select Check, an IRS-maintained public database, as those to which tax deductible contributions may be made.⁹

6 Email from Director, EO – Rulings & Agreements (Feb. 8, 2016), on file with TAS.

7 Email from Acting Director, TE/GE EO (Feb. 8, 2016), on file with TAS.

8 See IRS Pub. 4386, *Compliance Checks: Examination, Audit or Compliance Check?* (2006) noting “a compliance check is a review conducted to determine the following: Whether an organization is adhering to record keeping and information reporting requirements; Whether an organization’s activities are consistent with its stated tax-exempt purpose” and “[c]ompliance checks are not audits and do not directly relate to determining a tax liability for any particular period. Initial contact letters for compliance checks will include Pub 4386, Compliance Checks, explaining the distinction.”). The publication also notes that a compliance check “is a review of information and forms that we require organizations to file or maintain — for example, Forms 990, 990-T, 940, 941, W-2, 1099, or W-4. The check is a tool to help educate organizations about their reporting requirements and to increase voluntary compliance.”

9 EO Select Check is an online search tool, <http://apps.irs.gov/app/eos/>, that allows users to search for organizations eligible to receive tax deductible contributions, organizations whose tax exemption has been automatically revoked for not filing a Form 990-series return or notice for three consecutive years, and organizations that have filed a Form 990-N (also called an e-Postcard), an annual notice required to be filed by small exempt organizations.

FOCUS FOR FISCAL YEAR 2017

In Fiscal Year 2017, TAS will continue to:

- Advocate (including through the National Taxpayer Advocate's issuance of a Taxpayer Advocate Directive) that TE/GE address the needs of the 149 organizations TAS identified as having submitted Forms 1023-EZ that were erroneously approved. The organizations should be required to demonstrate they amended their articles to comply with the requirements for qualification as IRC § 501(c)(3) organizations;
- Evaluate, on the basis of the results of TE/GE's post-determination audits of Form 1023-EZ filers, the extent to which the audits show significant levels of noncompliance and whether the noncompliance could have been averted through simple revisions to Form 1023-EZ; and
- Evaluate the extent to which TE/GE's broader compliance framework yields information about the behavior, needs, and preferences of exempt organizations.