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#11**Overextended IRS Resources and IRS Errors in the Automatic Revocation and Reinstatement Process are Burdening Tax-Exempt Organizations****RESPONSIBLE OFFICIAL**

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**DEFINITION OF PROBLEM**

Over the past 18 months, as mandated by the Pension Protection Act of 2006, the IRS notified more than 440,000 organizations that their tax-exempt status had been automatically revoked because they failed to file required returns or notices for three consecutive years.<sup>1</sup> The IRS included these organizations on a list of those whose exempt status had been revoked, and, if they appeared on it, removed their names from another list of permissible recipients of tax-deductible contributions.

The National Taxpayer Advocate had several concerns about the manner in which the IRS would administer the automatic revocation process, and her concerns have been borne out.<sup>2</sup> For example:

- The IRS requires organizations seeking reinstatement to submit IRS Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, the same form about 60,000 other organizations file each year to request initial recognition of exempt status;<sup>3</sup>
- The increased volume in applications for exempt status coincides with staff reductions, so that fiscal year (FY) 2012 inventory is expected to be more than double the FY 2010

<sup>1</sup> The Pension Protection Act of 2006, Pub. L. No. 109-280 § 1223, 120 Stat. 780, 1090 (2006). The IRS notified organizations that they were no longer exempt beginning in June 2011. See *IRS Identifies Organizations that Have Lost Tax Exempt Status; Announces Special Steps to Help Revoked Organizations* (June 8, 2011), available at <http://www.irs.gov/newsroom/article/0,,id=240239,00.html>. An IRS online resource, Select Check, available at <http://apps.irs.gov/app/eos/>, includes a searchable list of organizations whose tax-exempt status was automatically revoked. As of August 9, 2012, there were 443,441 organizations on the list.

<sup>2</sup> National Taxpayer Advocate 2011 Annual Report to Congress 437 (Status Update: *The IRS Makes Reinstatement of an Organization's Exempt Status Following Revocation Unnecessarily Burdensome*).

<sup>3</sup> *Hearing on Public Charity Organizational Issues, Unrelated Business Income Tax, and the Revised Form 990, Hearing before the H. Comm. on Ways and Means, Subcomm. on Oversight*, 112th Cong. 2nd Sess., (July 25, 2012) 2 (testimony of Steven T. Miller, Deputy Commissioner of Services and Enforcement, Internal Revenue Service), available at [http://waysandmeans.house.gov/UploadedFiles/Miller\\_Testimony\\_7.25.pdf](http://waysandmeans.house.gov/UploadedFiles/Miller_Testimony_7.25.pdf) (noting that "We consistently receive about 60,000 applications for tax-exempt status each year. Most are requesting status under section 501(c)(3).").

level, and applications that require assignment to a reviewer now take nine months to be assigned;<sup>4</sup>

- Taxpayers who call the IRS for assistance will wait on average almost 20 minutes for assistance (up from ten minutes last year and seven minutes in 2010), and almost 40 percent of calls will go unanswered (up from 24 percent last year and 19 percent in 2010);<sup>5</sup>
- The IRS erroneously treated thousands of organizations as no longer exempt, yet does not provide administrative review that might have averted the errors or lessened their impact;<sup>6</sup> and
- TAS case receipts with exempt organization issues have increased more than fourfold from 2010 to 2012, a clear indication that the IRS's processes are causing significant hardship for these organizations.

The IRS provided transition relief for small organizations and is addressing the cause of a substantial number of automatic revocations. However, the reinstatement process remains unnecessarily burdensome and administrative review of automatic revocations is still unavailable. By every meaningful measure of taxpayer service, taxpayers are being harmed.

## ANALYSIS OF PROBLEM

### Background

The Pension Protection Act of 2006:

- Imposed a new annual reporting requirement, Form 990-N, *Electronic Notice (e-Postcard) for Tax-Exempt EOs Not Required to File Form 990 or 990-EZ*, on small exempt organizations (EOs);<sup>7</sup>

<sup>4</sup> Tax Exempt and Government Entities (TE/GE) Division Business Performance Review (BPR) FY 2012: Second Quarter 15 (May 23, 2012) available at [http://tege.web.irs.gov/lib/my-resources/TEGE\\_BPR\\_2nd\\_Quarter\\_FY2012.pdf](http://tege.web.irs.gov/lib/my-resources/TEGE_BPR_2nd_Quarter_FY2012.pdf) (reporting that there were 15,570 open determination cases in fiscal year (FY) 2010 and that TE/GE expects to have 40,304 open determination cases in FY 2012). See *Where Is My Exemption Application?*, available at <http://www.irs.gov/charities/article/0,,id=156733,00.html>, showing that in August 2012 TE/GE was assigning applications that were submitted in November 2011. Not all applications for exempt status must be assigned to a reviewer. For "plain vanilla" applications that do not require further development, the IRS either issues a determination letter or requests additional information within approximately 90 days. The IRS does not maintain information about processing times broken down by requests that can be disposed of at a screening stage and those that require further development. IRS response to TAS information request (Aug. 26, 2011).

<sup>5</sup> TE/GE BPR FY 2012: Second Quarter 27 (May 23, 2012) available at [http://tege.web.irs.gov/lib/my-resources/TEGE\\_BPR\\_2nd\\_Quarter\\_FY2012.pdf](http://tege.web.irs.gov/lib/my-resources/TEGE_BPR_2nd_Quarter_FY2012.pdf).

<sup>6</sup> Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2012-10-027, *Appropriate Actions Were Taken to Identify Thousands of Organizations Whose Tax-Exempt Status Had Been Automatically Revoked, but Improvements Are Needed* 9 (Mar. 30, 2012).

<sup>7</sup> IRC § 6033(i). Under IRC § 501(a) and (c)(3), some organizations (exempt organizations or EOs) devoted to charitable, religious, educational, or certain other purposes may be exempt from federal tax. Formerly, under IRC § 6033(a)(3)(A)(ii), these EOs with annual gross receipts of normally not more than \$5,000 were not required to file annual reports such as Form 990, *Return of Organization Exempt from Income Tax*, or Form 990-EZ, *Short Form Return of Organization Exempt from Income Tax*. With Rev. Proc. 83-23, 1983-1 C.B. 687, the IRS increased the gross receipts amount to \$25,000. For tax years beginning on or after January 1, 2012, the gross receipts amount is \$50,000. Rev. Proc. 2011-15, 2011-3 I.R.B. 332. Exceptions to the new reporting requirement include churches, their integrated auxiliaries, and conventions or associations of churches.

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- Provided for automatic revocation of tax-exempt status for failing to file a required return or e-Postcard for three consecutive years;<sup>8</sup> and
- Required an application for reinstatement of exempt status.<sup>9</sup>

The IRS can reinstate an organization's exempt status retroactively to the date of automatic revocation if the organization shows reasonable cause for its failure to file the required return or e-Postcard.<sup>10</sup> Under transitional relief provisions, the IRS will treat some organizations as having the requisite reasonable cause if they applied for reinstatement by December 31, 2012. Eligible organizations are those that were revoked for not filing a return or e-Postcard for their 2007, 2008, and 2009 tax years. In addition, to be eligible for transition relief, organizations must have:

- Had annual gross receipts of not more than \$50,000 in the most recently completed tax year;
- Not been required to file a Form 990 or 990-EZ prior to 2007; and
- Been eligible to file an e-Postcard in 2007, 2008, and 2009.<sup>11</sup>

These organizations can submit applications with a reduced user fee of \$100.<sup>12</sup>

The IRS implemented the Pension Protection Act by informing EOs of the new filing requirements, notifying them when their exempt status had been automatically revoked, and listing them on its Select Check database as having had their status automatically revoked. As of August 9, 2012, 443,441 EOs were listed as no longer exempt.<sup>13</sup> As of June 7, 2012, more than 18,000 organizations had applied for reinstatement.<sup>14</sup> Using the transitional relief provisions, as of June 7, 2012, the IRS had reinstated the exempt status of almost 8,000 organizations retroactively.<sup>15</sup> However, despite the National Taxpayer Advocate's urging,

<sup>8</sup> IRC § 6033(j).

<sup>9</sup> IRC § 6033(j)(2) provides that an organization must reapply for reinstatement following automatic revocation even if it was not required to apply for initial recognition of its tax exempt status.

<sup>10</sup> IRC § 6033(j)(3).

<sup>11</sup> Notice 2011-43, 2011-25 I.R.B. 882. For tax years beginning on or after January 1, 2010, organizations with gross receipts normally of \$50,000 or less may submit Form 990-N (e-Postcard). Rev. Proc. 2011-15, 2011-3 I.R.B. 322 (an increase from the earlier threshold of \$25,000 or less).

<sup>12</sup> Rev. Proc. 2011-36, 2011-25 I.R.B. 915. The user fee for filing Form 1023 is usually \$400 for EOs with gross receipts of \$10,000 or less and \$850 for those with gross receipts in excess of \$10,000. Rev. Proc. 2012-8, 2012-1 I.R.B. 235.

<sup>13</sup> Select Check, available at <http://apps.irs.gov/app/eos/>. In addition to containing a searchable list of organizations whose tax exempt status was automatically revoked, the tool provides searchable lists of organizations eligible to receive tax-deductible charitable contributions and organizations that have filed an e-Postcard.

<sup>14</sup> IRS response to TAS information request (Aug. 2, 2012). TE/GE received 11 applications for reinstatement in 2010, 6,199 in 2011, and 12,269 as of June 7, 2012. TE/GE closed 9,504 of these applications. *Id.*

<sup>15</sup> *Id.* TE/GE closed 7,908 applications for reinstatement pursuant to Notice 2011-43, with almost all applicants receiving retroactive reinstatement. The IRS also reinstated 1,596 organizations other than under the transitional relief provisions. The vast majority (1,390, or 87 percent) of these organizations had annual gross receipts of less than \$200,000 and only 26 obtained retroactive reinstatement. *Id.*

the IRS does not provide administrative review of its decision to treat an organization as having had its exempt status automatically revoked.<sup>16</sup>

### Automatic Revocations and Reduced Staff Cause Delays.

The IRS's Exempt Organization (EO) Rulings and Agreement staff in its Cincinnati Determinations office evaluate requests for reinstatement along with the approximately 60,000 routine applications for exempt status (*i.e.*, not resulting from automatic revocations) the IRS receives each year.<sup>17</sup> From 2009 to 2011, when the IRS issued the first notifications of automatic revocation, the number of full-time employees in the Determinations office decreased by about seven percent.<sup>18</sup> The volume of applications for reinstatement of exempt status and the number of employees who handle them are shown in Figure 1.11.1.

**FIGURE 1.11.1, Full-Time Cincinnati Determinations Staff vs. Applications for Reinstatement of Exempt Status<sup>19</sup>**



<sup>16</sup> National Taxpayer Advocate 2011 Annual Report to Congress 562 (Legislative Recommendation: *Provide Administrative Review of Automatic Revocations of Exempt Status, Develop a Form 1023-EZ, and Reduce Costs to Taxpayers and the IRS by Implementing Cyber Assistant*).

<sup>17</sup> IRS response to TAS information request (Aug. 2, 2012). In its BPR, EO reports on its "determination case receipts." Determination cases include applications submitted on Form 1023 as well as those submitted on Form 1024, *Application for Recognition of Exemption Under Section 501(a)*, and also other determinations such as public charity and private foundation status determinations, advance approval of scholarship grant procedures, and group determinations of tax-exempt status. IRS response to TAS information request (Aug. 26, 2011). For FY 2009, before there were any requests for reinstatement, determination case receipts were 71,836. TE/GE BPR FY 2011: Fourth Quarter 16 (Nov. 15, 2011), available at [http://tege.web.irs.gov/lib/my-resources/TEGE\\_BPR\\_4th\\_Quarter\\_FY2011.pdf](http://tege.web.irs.gov/lib/my-resources/TEGE_BPR_4th_Quarter_FY2011.pdf). For FY 2010, determination case receipts were 65,545, of which 11 were requests for reinstatement. For FY 2011, determination case receipts were 66,038, of which 6,199 were requests for reinstatement, leaving 59,839 routine requests. TE/GE BPR FY 2012: Second Quarter 15 (May 23, 2012) available at [http://tege.web.irs.gov/lib/my-resources/TEGE\\_BPR\\_2nd\\_Quarter\\_FY2012.pdf](http://tege.web.irs.gov/lib/my-resources/TEGE_BPR_2nd_Quarter_FY2012.pdf).

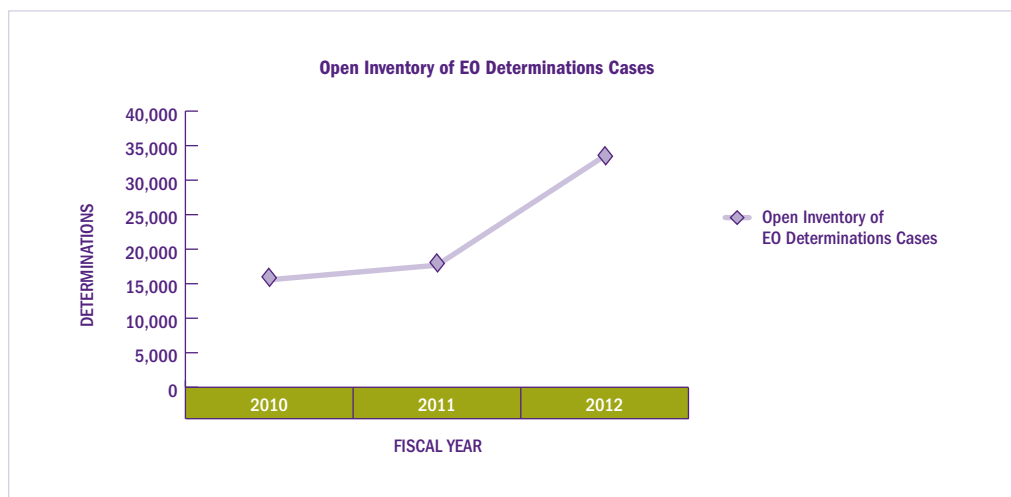
<sup>18</sup> AWSS Employee Support Services, Payroll/Personnel Systems, HR Reporting Section, <https://persinfo.web.irs.gov/track/workorg.asp> (showing all fulltime Cincinnati Determinations employees as 221, 208, and 206 as of the end of September in 2009, 2010, and 2011 respectively, a decrease of 6.8 percent).

<sup>19</sup> AWSS Employee Support Services, Payroll/Personnel Systems, HR Reporting Section, <https://persinfo.web.irs.gov/track/workorg.asp>.

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The consequence of the increased volume in applications handled by the same (or slightly smaller) Cincinnati Determination staff has been an increase in EO’s inventory of open (*i.e.*, unresolved) cases, as shown in Figure 1.11.2. The expected volume of open inventory for FY 2012 is more than double the FY 2010 level, increasing from 15,570 cases in FY 2010 to 33,505 expected in FY 2012.

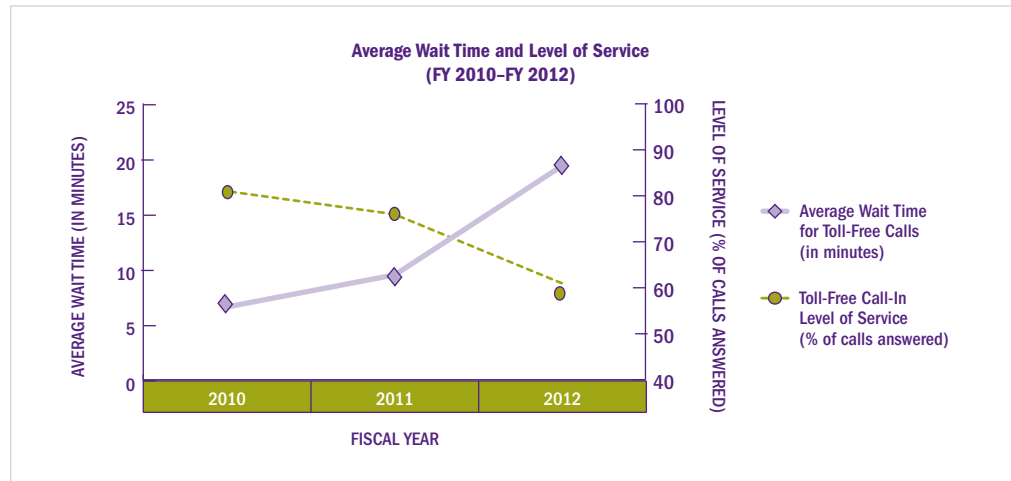
**FIGURE 1.11.2, EO Determinations Inventory<sup>20</sup>**



Applications that require assignment to a reviewer now take nine months to be assigned, up from the seven months cited in last year’s Annual Report as the time it takes to assign a Form 1023 to a reviewer.<sup>21</sup> Taxpayers who call TE/GE’s toll-free number for information now wait longer to have their calls answered (an almost 20-minute wait time is expected for FY 2012, up from seven minutes in FY 2010), and almost 40 percent of calls are expected to simply go unanswered, compared to only 19 percent unanswered in FY 2010, as shown in Figure 1.11.3.

<sup>20</sup> The FY 2010 open inventory consisted of 15,570 determinations cases. For FY 2011, the level was 17,677 cases, and for FY 2012, the level is expected to arrive at 33,505 cases. TE/GE BPR FY 2012: Second Quarter 15 (May 23, 2012) available at [http://tege.web.irs.gov/lib/my-resources/TEGE\\_BPR\\_2nd\\_Quarter\\_FY2012.pdf](http://tege.web.irs.gov/lib/my-resources/TEGE_BPR_2nd_Quarter_FY2012.pdf).

<sup>21</sup> See National Taxpayer Advocate 2011 Annual Report to Congress 449; Where Is My Exemption Application?, available at <http://www.irs.gov/Charities-&-Non-Profits/Where-Is-My-Exemption-Application%3F>.

**FIGURE 1.11.3, Average Wait Time for TE/GE Toll Free Calls vs. Percent of Calls Answered<sup>22</sup>**

Some taxpayers who needed assistance came to TAS; TAS case receipts with EO technical or Form 1023 processing issues jumped from 303 in FY 2010 to 1,666 in FY 2012, an increase of 450 percent.<sup>23</sup> This increase in TAS EO cases demonstrates that the IRS's processes are creating significant hardship for both new EOs and those whose exempt status was automatically revoked.<sup>24</sup>

In the two years preceding the automatic revocations, TE/GE devised a contingency plan “to meet whatever application processing needs [are] presented.”<sup>25</sup> The plan was to transfer backlogged applications from the Cincinnati Determinations office to EO Rulings and Agreement employees in Washington D.C.<sup>26</sup> TE/GE has not put this contingency plan into effect “[b]ecause we have not experienced timeliness issues processing the reinstatement cases.”<sup>27</sup> TAS cases and the data cited above show otherwise — *that by every meaningful measure of taxpayer service, the burden on new and revoked EOs applying for exemption has increased significantly.*

<sup>22</sup> TE/GE BPR FY 2012: Second Quarter 27 (May 23, 2012) available at [http://tege.web.irs.gov/lib/my-resources/TEGE\\_BPR\\_2nd\\_Quarter\\_FY2012.pdf](http://tege.web.irs.gov/lib/my-resources/TEGE_BPR_2nd_Quarter_FY2012.pdf).

<sup>23</sup> TAS Inventory Report, Year to Date Receipts by Primary Issue Code/Description Codes 160 and 460 for FY 2010 and FY 2012.

<sup>24</sup> IRC § 7811(a) authorizes the National Taxpayer Advocate to issue a Taxpayer Assistance Order if the National Taxpayer Advocate determines the taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the internal revenue laws are being administered by the Secretary. Treas. Reg. § 301.7811(a)(4)(ii) provides that “Significant hardship includes situations in which a system or procedure fails to operate as intended or fails to resolve the taxpayer’s problem or dispute with the IRS. A significant hardship also includes, but is not limited to: (A) An immediate threat of adverse action; (B) A delay of more than 30 days in resolving taxpayer account problems; (C) The incurring by the taxpayer of significant costs (including fees for professional representation) if relief is not granted; or (D) Irreparable injury to, or a long-term adverse impact on, the taxpayer if relief is not granted.”

<sup>25</sup> National Taxpayer Advocate 2011 Annual Report to Congress 437, 447 (Status Update: *The IRS Makes Reinstatement of an Organization’s Exempt Status Following Revocation Unnecessarily Burdensome*, IRS Comments).

<sup>26</sup> IRS response to TAS information request (Aug. 2, 2012).

<sup>27</sup> *Id.*

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TE/GE is not devising any new notices that might avert automatic revocations in the future, preferring to monitor whether the current notices are effective now that it has organizations' updated address information.<sup>28</sup> However, because more than 72,000 organizations that lost exempt status were covered by group exemption letters, TE/GE has concerns about the extent to which these organizations understand their filing obligations.<sup>29</sup> TE/GE is developing a questionnaire to send to a random sample of group ruling holders to learn more about how parent and subordinate organizations satisfy their reporting obligations.<sup>30</sup>

### Applying for Exempt Status is Unnecessarily Burdensome

As the National Taxpayer Advocate has pointed out, Form 1023, a 12-page form requiring as many as eight schedules, is unnecessarily detailed for many small organizations.<sup>31</sup> The National Taxpayer Advocate has recommended that TE/GE develop a Form 1023-EZ for small organizations as an alternative to Form 1023, and make Form 1023 available as a web-based interactive product. The Advisory Committee on Tax Exempt and Government Entities recommended against creating a Form 1023-EZ, but proposed that the IRS redesign Form 1023 as a short core form with supplemental supporting schedules and offer more educational tools about the form.<sup>32</sup> The Advisory Committee noted that reformatting Form 1023 in this way would reduce the need for smaller organizations to respond to certain questions that currently appear, lessening the burden on them.<sup>33</sup> While the Advisory Committee's recommendations address the National Taxpayer Advocate's concerns about unnecessary burden and information-collection, we note that the success of any revised form will depend on the details of the new design. A redesigned form with interactive directions that asks plain-language questions and specifies the documents and schedules the applicant must attach would minimize errors and omissions and reduce taxpayer burden. TE/GE is responding to the Advisory Committee's recommendation by creating an interactive version of Form 1023, but it does not plan to revise or reformat it because "such revisions would require resources beyond Exempt Organizations."<sup>34</sup> The National Taxpayer Advocate finds this response inadequate in light of demonstrated need, and recommends

<sup>28</sup> IRS response to TAS information request (Aug. 2, 2012).

<sup>29</sup> *Id.* A group of organizations affiliated with a central organization may apply for recognition of exempt status as a group, rather than each organization applying individually. The IRS may recognize a group of organizations as exempt and issue one determination letter that applies to more than one organization. The filing requirements for the subordinates in the group remain the same, but the central organization may file annual group returns for those subordinate members of the group that, among other things, have the same accounting period as the central organization. See Treas. Reg. § 6033-2(d) and IRS Publication 4573, *Group Exemptions*.

<sup>30</sup> *Id.*

<sup>31</sup> National Taxpayer Advocate 2011 Annual Report to Congress 562 (Legislative Recommendation: *Provide Administrative Review of Automatic Revocations of Exempt Status, Develop a Form 1023-EZ, and Reduce Costs to Taxpayers and the IRS by Implementing Cyber Assistant*).

<sup>32</sup> IRS response to TAS information request (Aug. 2, 2012); Advisory Committee on Tax Exempt and Government Entities (ACT) Report of Recommendations *Exempt Organizations: Form 1023 – Updating It for the Future 2*, 30-34 (June 6, 2012), available at [http://www.irs.gov/pub/irs-tege/tege\\_act\\_rpt11.pdf](http://www.irs.gov/pub/irs-tege/tege_act_rpt11.pdf).

<sup>33</sup> *Id.*

<sup>34</sup> IRS responses to TAS information request (Aug. 2, Aug. 17, 2012). The projected release date for an interactive Form 1023 is not yet known, nor has a user fee been determined. The interactive form will not be filed electronically.

that TE/GE work with the National Taxpayer Advocate, the Advisory Committee, and the appropriate state agencies and IRS functions to revise and reformat Form 1023.<sup>35</sup>

### **TE/GE Erroneously Placed Organizations on the List of Revoked Organizations, with Severe Consequences for Some.**

The decline in service to organizations requesting reinstatement of exempt status, coupled with the lack of administrative review, is particularly unfair to taxpayers that the IRS erroneously treated as no longer exempt. After the Treasury Inspector General for Tax Administration found that a programming problem existed, TE/GE identified more than 2,270 cases in which an organization was erroneously listed as having had its exempt status revoked, and 300 to 400 additional entities identified themselves as erroneously so listed.<sup>36</sup> The most common reason for the erroneous revocations was that IRS systems did not recognize subordinate organizations as part of a group return when the subordinates and the parent organizations had different accounting periods.<sup>37</sup> Upon discovering an erroneous revocation that appeared to be due to a systemic error, TE/GE researched whether other organizations were also erroneously treated as no longer exempt based on the same systemic condition. If so, TE/GE corrected their accounts as necessary, removed them from the revocation list, and notified them of the error. TE/GE worked with IRS Modernization & Information Technology Services to address programming errors.<sup>38</sup>

The IRS updates its records monthly, but if the IRS recognizes, even as soon as the day after a scheduled update, that it erroneously listed an organization as no longer exempt, the organization may not appear as exempt on IRS records for two months.<sup>39</sup> This can create serious problems for the organization, as some donors base contribution decisions exclusively on an organization's classification in IRS electronic records.<sup>40</sup> As the Chief Financial Officer of one organization erroneously placed on the list of revoked organizations noted,

<sup>35</sup> IRM 1.1.23.5(4)(h) (Feb. 1, 2007) provides that to accomplish its mission, EO "Coordinates with state agencies and Director TE/GE Customer Account Services on the design of EO forms and instructions and on the processing of EO forms."

<sup>36</sup> TIGTA, Ref. No. 2012-10-027, *Appropriate Actions Were Taken to Identify Thousands of Organizations Whose Tax-Exempt Status Had Been Automatically Revoked, but Improvements Are Needed* 9 (Mar. 30, 2012). See *ABA Meeting: Official Encourages Contact from EOs with Wrongly Revoked Exemptions*, Tax Notes Today (May 11, 2012), available at 2012 TNT 93-33, in which an IRS official noted "the IRS has made corrections for 300 to 400 organizations that came to the IRS and explained why the revocations were erroneous."

<sup>37</sup> IRS response to TAS information request (Aug. 2, 2012). Other erroneous revocations occurred when IRS systems did not recognize EOs with more than one Employer Identification Number (EIN) that filed a return showing only one EIN; when IRS systems did not recognize, and therefore did not accept, an e-Postcard from organizations that had never previously filed a return or application for exempt status; when the IRS was unaware that state credit unions no longer had a filing obligation because they had become federally chartered; and when IRS systems had not been updated to reflect an IRS determination that the EO did not have a filing obligation, or the IRS erred in advising the organization that it did not have a filing obligation.

<sup>38</sup> IRS response to TAS information request (Aug. 2, 2012).

<sup>39</sup> See *Correction: Some EOs Seeking Reinstatement May Not Appear on IRS Website For Up to 2 Months*, Tax Notes Today (May 15, 2012), available at 2012 TNT 95-9.

<sup>40</sup> TAS, Taxpayer Advocate Management Information System (TAMIS) Case File 272001. Despite the IRS's assertion that a letter from the IRS affirming the organization's exempt status is "good as gold" (see *ABA Meeting: Official Encourages Contact from EOs with Wrongly Revoked Exemptions*, Tax Notes Today (May 11, 2012), available at 2012 TNT 93-33), donors may not be able to integrate such a letter into their electronic grant making systems, which automatically consult IRS electronic records only.



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The action of our contributor in withholding their gift adversely impacts us in two ways: we don't have the gift, and the contributor may be asking 'What's wrong with [the organization] that the IRS pulled the plug on them?' The fact that we are ineligible to apply for grants whose filing deadlines will pass before our name is restored to the IRS website creates an irreparable harm to our organization.<sup>41</sup>

In addition, the IRS may initiate a compliance check, informing the organization that because its exemption was automatically revoked, it may no longer be eligible to sponsor an IRC § 403(b) pension plan.<sup>42</sup> State regulatory authorities may inform the organization that they are aware of the automatic revocation and remind the organization of possible liability under state law if it represents that donations are deductible when they are not.<sup>43</sup>

These consequences pose extreme hardship for organizations whose existence depends on their IRS list status. A process of administrative review might allow an organization to quickly resolve any errors and prevent it from being listed as no longer exempt, or at least minimize the period during which it is treated as having had its exempt status revoked.

### CONCLUSION

In conclusion, the National Taxpayer Advocate preliminarily recommends that:

1. If TE/GE adopts the Advisory Committee's recommendation that it not develop a Form 1023-EZ, it should work with the National Taxpayer Advocate, the Advisory Committee, and appropriate state agencies and IRS functions to implement the committee's recommendations that it redesign Form 1023 to include a short core form with supplemental supporting schedules, and develop more educational tools about the form. The redesigned form should be interactive, have plain-language questions, and specify the documents and schedules the applicant needs to attach.
2. TE/GE should augment existing electronic databases with a smaller electronic file or "addendum" that can be updated more frequently than once a month.
3. TE/GE should provide for administrative review of an organization's claim that it was, or is about to be, erroneously treated as no longer tax exempt.
4. TE/GE should seek additional staffing for review of applications for exempt status and reinstatements and for phone assistance to bring its service at least back to pre-revocation levels if not better.

<sup>41</sup> TAS, TAMIS Case File 5272001, email from taxpayer's Chief Executive Officer to Deputy Director of Communications, Office of Rep. Israel (Mar. 12, 2012), on file with TAS. When TAS asked the IRS what caused this organization to be erroneously treated as no longer exempt, the IRS responded, "The IRS system does not reflect that this organization was ever automatically revoked. However, the IRS system does show that the organization's account was updated to a status that indicates that the organization was no longer in business. Once notified by the organization, the status was corrected." IRS response to TAS information request (Aug. 2, 2012). We find it disturbing that the IRS could be unaware of what actually happened in this case.

<sup>42</sup> TAS TAMIS Case File 5213829.

<sup>43</sup> TAS TAMIS Case File 5240782.

## IRS COMMENTS

Congress passed the Pension Protection Act in 2006, amending IRC § 6033. The law now requires most tax-exempt organizations to file an annual information return or notice with the IRS. For small organizations, the law imposed a reporting requirement (e-Postcard, or Form 990-N) for tax years beginning after December 31, 2006. The new law also provides for the automatic revocation of the tax-exempt status of any organization that does not file a required return or notice for three consecutive years. In addition, the law states that all organizations automatically revoked by operation of law “must apply in order to obtain reinstatement of such status regardless of whether such organization was originally required to make such an application.”<sup>44</sup> Therefore, as required by the statute, automatically revoked organizations must file an application for exemption to have their tax-exempt status reinstated, just as any other organization seeking IRS recognition of tax-exempt status.

The IRS is proud of its implementation of Congress’ mandate. Over several years, the IRS took unprecedented steps in bringing awareness of the provision to the exempt organizations community through targeted as well as general outreach. The IRS also provided small organizations additional time for filing after releasing a preliminary list of organizations for which we had not received a filing. Slightly larger organizations were also given an opportunity to come into compliance without losing their tax-exempt status. In addition, after the revocation list was released, the IRS provided a special transition process for smaller organizations to have their tax-exempt status reinstated. In the years building up to the imposition of the automatic revocation, and in this period following revocation, the IRS has continually taken steps to assist EOs, especially those that are smaller.

The IRS agrees with the National Taxpayer Advocate that it could be beneficial to taxpayers to redesign the Form 1023 as an electronic short core form with supplemental supporting schedules, as recommended by the Advisory Committee on Tax Exempt and Government Entities (ACT) in its report released in June 2012.<sup>45</sup> This type of total redesign would, however, require resources from many parts of the IRS, including information technology. Because the IRS must balance a number of competing needs, we cannot presently predict when we can undertake the full redesign. However, to more immediately address the issue, the IRS asked the ACT to suggest steps to assist taxpayers with the application process in the interim. In response, the ACT suggested that the IRS post previously developed educational information on the IRS website to assist applicants. The IRS is going one step further, and is in the process of incorporating that previously developed information into an interactive web-based version of the existing Form 1023 that applicants can prepare online and then print and send into the IRS for review. We expect to make the interactive form available during the next calendar year.

<sup>44</sup> Pension Protection Act of 2006, Pub. L. No. 109-280 § 1223, 120 Stat. 780, 1090 (2006).

<sup>45</sup> Advisory Committee on Tax Exempt and Government Entities (ACT), *Report of Recommendations Exempt Organizations: Form 1023- Updating It for the Future* 32 (June 6, 2012), available at [http://www.irs.gov/pub/irs-tege/tege\\_act\\_rpt11.pdf](http://www.irs.gov/pub/irs-tege/tege_act_rpt11.pdf).

## Overextended IRS Resources and IRS Errors in the Automatic Revocation and Reinstatement Process are Burdening Tax-Exempt Organizations

The IRS understands that delayed notification of reinstatement can be a hardship for organizations that have been erroneously revoked. When the IRS determines that an organization has been erroneously revoked, it issues a letter advising the organization of the error, and this letter may be used by the organization to establish its tax-exempt status with donors, the public, or other government agencies.

The IRS also understands that organizations and their contributors often wish to use IRS's online resources, rather than a letter, to confirm tax-exempt status. For that reason, the IRS has been taking steps to increase the speed at which information about the tax-exempt status of organizations is updated on its publicly available resources. To provide the public with more timely information about the tax-exempt status of organizations, in January, 2011, the IRS began updating its publicly available online resources on a monthly rather than quarterly basis. Adding more frequent updates or creating a smaller electronic file or "addendum" would require additional programming and resources, which will have to be balanced with other competing IRS needs and systems limitations.

Under the PPA, automatic revocation of exemption occurs by operation of law. Because the IRS makes no determination regarding the automatic revocation, there is no IRS conclusion or determination to review. Automatic revocations are generated from data within the IRS BMF, which indicates the organizations that have failed to meet their filing requirements for three consecutive years. When passing the PPA, Congress recognized that the taxpayer information in the IRS systems may no longer be correct and that the new filing requirements could assist the IRS in updating this information and ensuring the accuracy of IRS systems going forward. Because the IRS also recognizes that automated systems can produce mistaken results, either because of programming issues or because of faulty data, the IRS has told organizations to notify the IRS if they believe they have been erroneously included on the Automatic Revocation List. The IRS will correct any mistakes.<sup>46</sup>

Preliminarily, approximately 450,000 organizations have been automatically revoked for failing to file an annual notice or return for three consecutive years. As of November 5, 2012, the IRS had received approximately 27,000 applications for reinstatement of tax-exempt status from automatically revoked organizations (approximately six percent of revoked organizations), and had closed approximately 17,000 of those applications (approximately 63 percent of requested reinstatements).

The IRS appreciates the importance of processing applications for exemption in a timely manner and providing quality customer service at our call sites. We have initiated a

<sup>46</sup> See *Automatic Exemption Revocation for Non-Filing: Frequently Asked Questions*, at <http://www.irs.gov/Charities-&-Non-Profits/Automatic-Exemption-Revocation-for-Non-Filing:-Frequently-Asked-Questions-2>. The answer to Frequently Asked Question 10, ("If an organization on the Auto-Revocation List has documentation that it met its filing requirement for one or more years during the three-year period, what should it do?") is: "An organization possessing documentation (an IRS receipt for a filed return, for example) that shows it has not failed to file for three consecutive years should contact Customer Account Services, or send the documentation directly to the Exempt Organizations Account Unit." The answer to Frequently Asked Question 11, ("If an organization on the Auto-Revocation List has a letter from the IRS stating that it does not have an annual filing requirement, what should it do?") is: "An organization with a letter from the IRS stating that it does not have an annual filing requirement should contact Customer Account Services."

number of efficiencies to improve the timeliness of our review of applications for tax-exempt status. Rather than assigning all cases to an agent for development, we put in place a screening system to fast-track those applications that are complete and require little or no further development.

This process has dramatically decreased the number of cases that need to be assigned for full development. For example, in FY 2012, 70 percent of all application cases were reviewed and closed within approximately 120 days during this initial technical screening process. Organizations whose applications cannot be completed through technical screening are sent letters informing them that more development of their application is needed.

To give applicants a sense of how long the wait could be before their application is assigned to a reviewer, we post on the IRS website (“Where’s My Application”) the date of applications currently being assigned. In an abundance of caution, however, the date given on the website is the oldest date of applications awaiting assignment. Most applications requiring full development are assigned well before that date, and the average wait time for full development applications at this time is roughly five months from the date we receive the application. We know the web page has created some confusion and we are in the process of revising the “Where’s My Application” web page and letters to applicants to provide better information on wait times.

In addition, we continue to improve our process for reviewing applications and provide more education to applicants so more applications may be reviewed and closed during the screening process. We are confident that the new interactive Form 1023 will help in this respect.

To provide a high level of assistance to the ever-increasing number and complexities of tax-exempt organizations, while using our resources most effectively, the IRS takes a balanced approach towards customer service. First, the IRS website provides numerous resources to exempt organizations to assist them with all compliance issues. For automatic revocation specifically, we have developed “Frequently Asked Questions” targeted topic pages and tax tips directed towards both organizations and their contributors, to answer most auto-revocation scenarios. We encourage organizations to look to the website first to find information regarding their situations. Because website availability is not limited by work hours or staffing, it is a good way for organizations to instantly get the information they need at their convenience.

Second, the IRS recognizes that there may be some questions/concerns that cannot be answered by the website. For those less usual circumstances, call site staff, who are trained and dedicated solely to exempt organization issues, are available to provide assistance. In some cases, Rulings and Agreements staff also provide technical support to individuals on revocation/reinstatement issues. Unfortunately, people do not always go to the website first to find the answers to their questions, but instead go directly to the call site, which can lead to longer wait times for all callers. We will continue to improve our educational efforts to encourage customers to review the website for their questions before contacting the call site.

The IRS remains committed to ensuring a fair and effective implementation of section 1223 of the PPA with the automatic revocation and reinstatement process created by section 1223 of the PPA. Despite the increase in applications due to requests for reinstatement, the IRS has maintained a high level of service to organizations and the public, and will continue look for additional ways to provide quality assistance.

### Taxpayer Advocate Service Comments

The National Taxpayer Advocate commends TE/GE for developing an interactive version of the present Form 1023, which would be an improvement, but we retain our recommendation that TE/GE heed the recommendation of its Advisory Committee to redesign the form in ways that will significantly lessen the burden on taxpayers.<sup>47</sup> Without a more definitive commitment, it is not clear that TE/GE would actually undertake the redesign even if resources were readily available. Similarly, TE/GE does not articulate any objection, beyond resource considerations, to updating its electronic database more frequently than once a month, but doing so does not appear to be a priority. We therefore retain our recommendation that TE/GE provide these updates. We note that the tax exempt sector fulfills an essential role in the charitable, civic, scientific, and educational sectors of our economy, among others, and the IRS's failure to immediately update its records with respect to eligible charities unnecessarily harms these entities and undermines public policy.<sup>48</sup>

Finally, we retain our recommendation that TE/GE make administrative review available, a proposal that TE/GE rejects on the grounds that revocations under PPA occur automatically and thus there is no "determination" to review. At the same time, TE/GE acknowledges that inaccurate automatic revocations can result from programming errors or faulty data. Nothing in PPA prevents or prohibits TE/GE from establishing a regularized procedure for taxpayers to alert the IRS about an erroneous revocation. TE/GE's ad hoc approach of correcting mistakes that single taxpayers bring to its attention is not a substitute for publicly available, established procedures for requesting review, which standards of tax administration and administrative procedure require.

<sup>47</sup> The "interactive web-based version of the existing Form 1023 that applicants can prepare online and then print and send into the IRS for review," referred to in the IRS's response, sounds very similar to Cyber Assistant, a web-based software program the IRS announced would be available in 2010, and an initiative the National Taxpayer Advocate supported. See National Taxpayer Advocate 2011 Annual Report to Congress 562 (Legislative Recommendation: *Provide Administrative Review of Automatic Revocations of Exempt Status, Develop a Form 1023-EZ, and Reduce Costs to Taxpayers and the IRS by Implementing Cyber Assistant*). The release of Cyber Assistant was delayed until further notice. IRM 3.45.1.11.6.2 (Jan. 1, 2012).

<sup>48</sup> The Independent Sector, a nonpartisan coalition of approximately 600 organizations founded in 1980, reports that the nonprofit sector provides 5.5 percent of the nation's entire gross domestic product or \$751 billion worth of output. Moreover, "[i]n 2009, nonprofits employed 13.5 million individuals, or approximately 10% of the country's workforce. To provide a comparison, more people work in the sector than in the finance industry, including insurance and real estate, combined." Additionally, "[e]mployees of nonprofit organizations account for 9% of wages paid in the U.S. in 2009, and the nonprofit sector paid \$668 billion in wages and benefits to its employees." (Fn refs. omitted). The Economic Sector, *The Sector's Economic Impact*, available at [http://www.independentsector.org/economic\\_role](http://www.independentsector.org/economic_role).

The National Taxpayer Advocate is encouraged by TE/GE's initiatives to improve the efficiency with which it processes applications for exempt status. However, TE/GE reports that its new screening procedures reduce the number of days it takes to *review and close* some cases. It is not clear whether this reduced time includes the number of days the IRS has the application but has not begun to review it. Moreover, the reduced processing time for cases that need *little or no development* is 120 days — four months. At any rate, in spite of its new procedures, TE/GE's June, 2012, volume of open inventory was 36,034 cases, compared to the June, 2011, volume of 17,451 cases, so while taxpayers might have been even worse off without the new procedures, the sheer volume of applications may be outpacing the gains in efficiency.<sup>49</sup>

## Recommendations

To improve the automatic revocation and reinstatement process, and to lessen the burden on taxpayers seeking recognition of exempt status, the National Taxpayer Advocate recommends that:

1. If TE/GE adopts the Advisory Committee's recommendation that it not develop a Form 1023-EZ, it should work with the National Taxpayer Advocate, the Advisory Committee, and appropriate state agencies and IRS functions to implement the committee's recommendations that it redesign Form 1023 to include a short core form with supplemental supporting schedules, and develop more educational tools about the form. The redesigned form should be interactive, have plain-language questions, and specify the documents and schedules the applicant needs to attach.
2. TE/GE should augment existing electronic databases with a smaller electronic file or "addendum" that can be updated more frequently than once a month.
3. TE/GE should provide for administrative review of an organization's claim that it was, or is about to be, erroneously treated as no longer tax exempt.
4. TE/GE should seek additional staffing for review of applications for exempt status and reinstatements, and for phone assistance to bring its service at least back to pre-revocation levels if not better.

<sup>49</sup> TE/GE BPR FY 2012: Third Quarter 27 (Aug. 16, 2012) available at <http://tege.web.irs.gov/article.asp?category=resources&title=reports-budget-it&path=/my-resources/reports-budget-it>.