



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

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

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

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], suffered [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

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