

Many Groups Granted Tax-Exempt Status Don't Qualify

by Fred Stokeld

Nearly half of organizations that received tax-exempt status after completing a streamlined exemption application didn't qualify for section 501(c)(3) classification, a new study has found.

The 46 percent of organizations that failed the section 501(c)(3) organizational test did so because their articles of incorporation lacked an adequate purpose clause, dissolution clause, or both, according to the Taxpayer Advocate Service, which studied a sample of organizations that received exemption after filing Form 1023-EZ.

Moreover, a requirement added in 2018 that says applicants must describe their missions or most significant activities in 255 characters or less didn't appear to prevent erroneous approvals. In fact, the erroneous approval rate rose from 42 percent in 2017 to 46 percent in 2019, according to the study, released January 8 as part of the national taxpayer advocate's 2019 annual report to Congress.

Recommendations

TAS recommended that the IRS require Form 1023-EZ users to submit their organizational documents as part of their applications and make a determination only after reviewing those documents. It also said the IRS should review applicants' websites, if any, before making a determination.

The IRS should find out how frequently applicants' descriptions of their missions and activities on the application result in referrals for further review, TAS said. If further review is infrequent, the IRS should conduct additional training on procedures for evaluating the applications, it added.

Finally, rather than determining whether an applicant's mission or activity is "within the scope" of section 501(c)(3), IRS reviewers should determine whether an applicant's descriptions of its missions and activities clearly identify an exempt purpose, TAS said.

Not Surprising

The findings are no surprise to Charles M. Watkins of Webster Chamberlain & Bean LLP, who has long argued that Form 1023-EZ doesn't seek enough information and enables unqualified applicants to obtain section 501(c)(3) status.

The TAS report "simply reinforces the conclusions of its prior studies: Form 1023-EZ does not collect enough data from applicants for the (apparently ill-trained) IRS staff to make accurate judgments about whether the applicants qualify for exemption under section 501(c)(3), and IRS staff are not screening out applications from ineligible organizations," Watkins told *Tax Notes*.

Appropriate amendments should be mandatory, and IRS reviewers should be required to review an applicant's statement of activities and website and question anything suggesting that the applicant has a substantial purpose other than those described in section 501(c)(3), Watkins said.

If Form 1023-EZ is retained, it should be revised to require submission of governing documents, Watkins said.

Also, appropriate amendments should be mandatory, and IRS reviewers should be required to review an applicant's statement of activities and website and question anything suggesting that the applicant has a substantial purpose other than those described in section 501(c)(3), according to Watkins.

TAS should also try to find out whether Form 1023-EZ filers submit Form 990-EZ or Form 990 information returns for their first or second fiscal year, and if so, whether they have engaged fundraising firms, Watkins said.

"This may shed light on whether the applicant truthfully attested that it is eligible to use Form 1023-EZ (because it did not expect its annual gross receipts to exceed \$50,000 during its first three fiscal years)," Watkins explained.

The findings are troubling but not surprising, said Alexander L. Reid of Morgan, Lewis & Bockius LLP.

The technical requirements to form a nonprofit organization are beyond the capabilities

of most people without the assistance of specialized legal counsel, Reid said. The problem lies not with the Form 1023-EZ, but with regulatory compliance at the state level, he said.

"The IRS should be commended for attempting to make things easier for small nonprofit organizations," Reid said. He added, however, that he fears there will be more retroactive revocations of organizations that "never met the organizational test for 501(c)(3)."

"It would be a shame for this effort to boomerang on organizations with significant penalties for failure to file corporate income tax returns solely as a result of a technical defect in their governing documents," said Reid, who expressed hope that the IRS will offer some sort of relief. ■