

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



More Information Is Needed to Make Informed Decisions on Streamlined Applications for Tax Exemption

October 3, 2022

Report Number: 2023-10-001

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

HIGHLIGHTS: More Information Is Needed to Make Informed Decisions on Streamlined Applications for Tax Exemption

Final Report issued on October 3, 2022

Report Number 2023-10-001

Why TIGTA Did This Audit

The overall objective of this review was to assess the efficiency of the streamlined application process for recognition of tax-exempt status under Internal Revenue Code (I.R.C.) § 501(c)(3), including 1) whether the application provides the IRS with sufficient information to approve or deny the organization for tax-exempt status, and 2) the use of resources and processing times in making determinations.

Impact on Tax Administration

The Exempt Organizations function's Determinations unit is responsible for reviewing applications to determine whether organizations qualify for tax exemption and issuing determination letters recognizing or denying tax-exempt status. Without sufficient information on the streamlined application, the IRS may approve tax exemption for organizations that do not meet the legal requirements, and could allow unscrupulous individuals to use the exemption for illegal activities. This could also diminish public trust in legitimate tax-exempt organizations.

Form 1023-EZ
3 pages



Standard
Form 1023
26 pages



Form 1023-EZ was designed to reduce inventory backlogs for processing Forms 1023 and the burden on smaller organizations applying for tax-exempt status.

What TIGTA Found

On July 1, 2014, the IRS released Form 1023-EZ, *Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, a simplified electronic application for smaller organizations to request and obtain exemption from Federal income tax as an organization described in I.R.C. § 501(c)(3) tax-exempt status. Form 1023-EZ requires applicants to attest, rather than demonstrate, that they meet the requirements for I.R.C. § 501(c)(3) status. For example, Form 1023-EZ applicants are not required to submit their organizing documents to the IRS; they instead attest that they meet organizational requirements.

Based on our assessment of internal and external stakeholder opinions, States' reporting requirements, comparison with the information required on the long application form, our testing of the application process, and limited examination compliance efforts, we determined that the information provided on the Form 1023-EZ is insufficient to make an informed determination about tax-exempt status and does not educate applicants about eligibility requirements for tax exemption. TIGTA obtained I.R.C. § 501(c)(3) status for four of five nonexistent organizations. The IRS correctly identified one of our fictitious applications as potentially ineligible and sent a request for additional documentation. Our undercover testing illustrates vulnerabilities in the IRS's tax-exempt status determination process.

The IRS relies on a Form 1023-EZ examination strategy to detect noncompliance after organizations are approved; however, less than 1 percent of tax-exempt organizations are examined each year. In addition, online guidance for the Form 1023-EZ is inaccurate. The online web page used to apply for tax-exempt status includes educational links to assist Form 1023-EZ applicants. However, one of the educational links takes the applicant to a web page containing inaccurate information for applicants using the Form 1023-EZ.

What TIGTA Recommended

TIGTA recommended that the IRS: 1) revise the activities description narrative on Form 1023-EZ, 2) assess the feasibility of requiring applicants to submit their organizing documents as an attachment to Form 1023-EZ, 3) notify applicants when additional time is needed to process their Form 1023-EZ applications, and 4) update online guidance with accurate information on the application process for Form 1023-EZ filers.

IRS management agreed with the second and fourth recommendations. In addition, the IRS will consider notifying applicants when their submissions need additional time to process. However, the IRS believes that requiring detailed activity descriptions is unnecessary to make determination decisions.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

U.S. DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20024

October 3, 2022

MEMORANDUM FOR: COMMISSIONER OF INTERNAL REVENUE

Heather Hill

FROM: Heather M. Hill
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – More Information Is Needed to Make Informed
Decisions on Streamlined Applications for Tax Exemption
(Audit # 202110017)

The overall objective of this review was to assess the efficiency of the streamlined application process for recognition of tax-exempt status under Internal Revenue Code § 501(c)(3), including 1) whether the application provides the Internal Revenue Service with sufficient information to approve or deny the organization for tax-exempt status, and 2) the use of resources and processing times in making determinations. This review is part of our Fiscal Year 2022 Annual Audit Plan and addresses the major management and performance challenge of *Improving Tax Reporting and Payment Compliance to Reduce the Tax Gap*.

Management's complete response to the draft report is included as Appendix III.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Bryce Kisler, Acting Assistant Inspector General for Audit (Management Services and Exempt Organizations).

Table of Contents

Background.....Page 1

Results of Review.....Page 6

Form 1023-EZ Does Not Require Sufficient Information to
Make an Informed Decision and Does Not Educate
Applicants About Tax-Exempt Status.....Page 6

Recommendations 1 and 2:.....Page 18

Recommendation 3:.....Page 19

Online Guidance for Form 1023-EZ Is Inaccurate.....Page 19

Recommendation 4:.....Page 20

Appendices

Appendix I – Detailed Objective, Scope, and Methodology.....Page 21

Appendix II – Form 1023-EZ Application Review Process.....Page 23

Appendix III – Management’s Response to the Draft Report.....Page 25

Appendix IV – Additional Office of Audit Comments on
Management’s Response.....Page 30

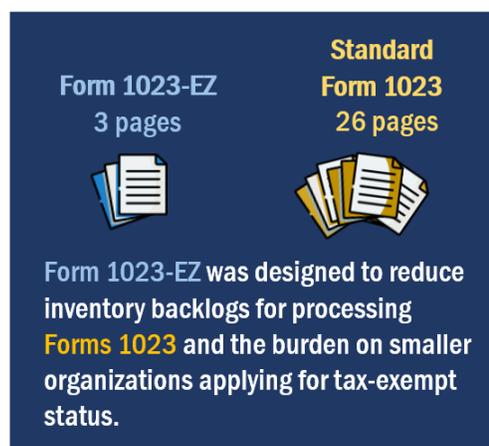
Appendix V – Abbreviations.....Page 32

Background

The Exempt Organizations (EO)/Government Entities function (hereafter referred to as the EO function) within the Internal Revenue Service's (IRS) Tax Exempt and Government Entities (TE/GE) Division includes two primary operational areas: the Rulings and Agreements office and the Examinations unit. The Determinations unit, one component of the Rulings and Agreements office, is responsible for reviewing applications to determine whether the organizations qualify for tax-exempt status and issuing determination letters recognizing or denying exempt status. The Examinations unit is responsible for conducting examinations of returns filed by tax-exempt organizations.

Form 1023-EZ, *Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*

Prior to July 2014, all organizations seeking recognition of exemption from Federal income tax under Internal Revenue Code (I.R.C.) § 501(c)(3) applied using Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*. On July 1, 2014, the IRS released Form 1023-EZ, a simplified electronic application form for smaller organizations to request and obtain exemption from Federal income tax as an organization described in I.R.C. § 501(c)(3). At the time of release, Form 1023-EZ was three pages long compared with the standard 26-page Form 1023. Form 1023-EZ was designed to reduce inventory backlogs for processing Forms 1023 and the burden on smaller organizations applying for tax-exempt status.



The image is a dark blue rectangular box containing text and icons. On the left, it says 'Form 1023-EZ' in white, with '3 pages' below it and a small icon of a single document. On the right, it says 'Standard Form 1023' in yellow, with '26 pages' below it and a small icon of a stack of documents. Below these, a paragraph in white text states: 'Form 1023-EZ was designed to reduce inventory backlogs for processing Forms 1023 and the burden on smaller organizations applying for tax-exempt status.'

Any organization can file Form 1023 to apply for recognition of exemption from Federal income tax under I.R.C. § 501(c)(3), but only certain organizations are eligible to file Form 1023-EZ. Revenue Procedure 2022-5 includes 25 types of organizations that are ineligible to file using the simplified form, regardless of their financial situation.¹ Figure 1 summarizes Form 1023-EZ financial eligibility requirements.

¹ Ineligible organizations include organizations formed under the laws of a foreign country, churches, schools, and hospitals.

**Figure 1: Form 1023-EZ
Eligibility Requirements**

Form 1023-EZ

*Streamlined Application for Recognition of
Exemption Under Section 501(c)(3)*

**Eligible to file if all of the following
criteria are met:**

- ✓ The organization has projected annual gross receipts of \$50,000 or less in the current taxable year and the next two years.
- ✓ The organization had annual gross receipts of \$50,000 or less in each of the past three years for which the organization was in existence.
- ✓ The organization has total assets the fair market value of which does not exceed \$250,000.

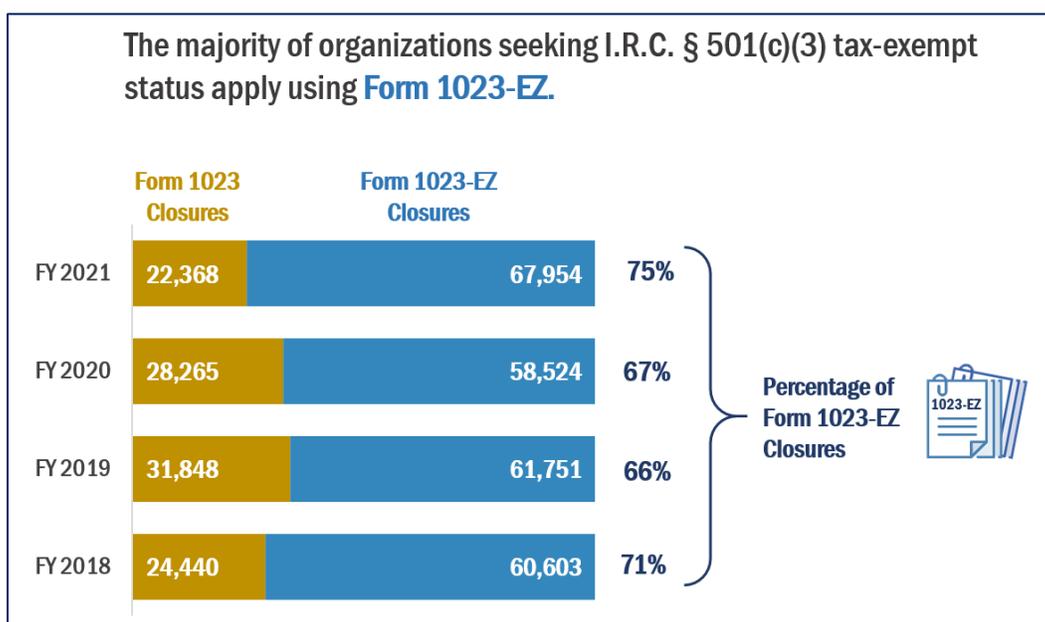
Source: Revenue Procedure 2022-5.

Form 1023-EZ is a condensed version of Form 1023, consisting mainly of checkboxes, and requires applicants to attest, rather than demonstrate, that they meet the requirements for I.R.C. § 501(c)(3) tax-exempt status. For example, Form 1023-EZ applicants are not required to submit their organizing documents to the IRS; they instead attest that they meet organizational requirements for tax exemption.² In January 2018, the IRS revised Form 1023-EZ to require a brief description of an organization’s mission or most significant activities, limited to 250 characters. The application fee to submit Form 1023-EZ is \$275, while the Form 1023 application costs \$600. Once the IRS makes a determination to approve or deny tax-exempt status, the organization’s determination letter can be found on the IRS’s website.

The majority of organizations seeking I.R.C. § 501(c)(3) tax-exempt status apply using the Form 1023-EZ application. For example, in Fiscal Year (FY) 2021, the IRS closed over 90,000 applications for I.R.C. § 501(c)(3) tax-exempt status and 75 percent of them were Form 1023-EZ applications. Figure 2 compares Form 1023 and Form 1023-EZ applications closures for FYs 2018 through 2021.

² An organizing document is the trust instrument, corporate charter, articles of incorporation, articles of association, or other written instrument by which the organization is created under State law. The organizing documents must limit the organization's purposes to the exempt purposes in I.R.C. § 501(c)(3) and must not expressly empower it to engage, other than as an insubstantial part of its activities, in activities that are not in furtherance of one or more of those purposes. The organizing documents should also contain a provision ensuring that an organization’s assets are distributed for an exempt purpose in the event of dissolution.

Figure 2: Forms 1023 and 1023-EZ Closures for FYs 2018 Through 2021



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of Employee Plans/Exempt Organizations Determination System data.³

Form 1023-EZ application review process

All Form 1023-EZ applications are submitted electronically and either assigned to a tax examiner (TE) for standard review or selected for a pre-determination review by a revenue agent (RA) (sometimes referred to as a specialist in IRS procedures). A pre-determination review is a more in-depth review of the application, similar to what a Form 1023 application's review entails. The TE will use only information provided on the application or information that is already part of IRS records. If the TE completes the review steps and the application is not returned incomplete or referred to a specialist because further development is warranted to determine if the organization meets requirements for exemption, the application will be approved.⁴

During a standard review, if the TE identifies any issue(s) requiring the advice of an RA, the TE will request "specialist involvement." The specialist will conduct research and advise the TE to either continue processing the case, return the application incomplete, or send the case to be processed by an RA as a TE referral.

Applications selected for a pre-determination review and TE referral cases are processed by the RAs. The RAs perform additional research and request additional information from the organization to make a determination, including organizing documents, description of activities, and financial information, as needed. Based on this more detailed review, the application will be approved, disapproved, returned incomplete, or withdrawn by the applicant.⁵ Figure 3 illustrates the Determinations unit's Form 1023-EZ application review process.

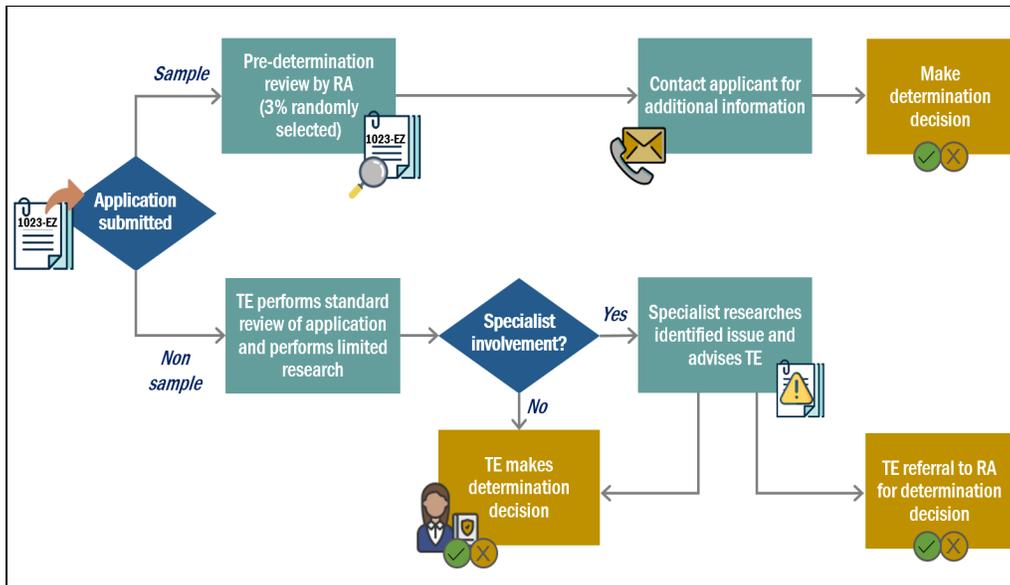
³ The Employee Plans/Exempt Organizations Determination System is a legacy system that generates determination letters and serves as a system of records.

⁴ Returned incomplete is when an application is returned to the applicant as incomplete for reasons such as Employer Identification Number or application fee issues.

⁵ See Appendix II for more information about the Form 1023-EZ application review process.

**More Information Is Needed to Make Informed
Decisions on Streamlined Applications for Tax Exemption**

Figure 3: Determinations Unit Form 1023-EZ Application Review Process



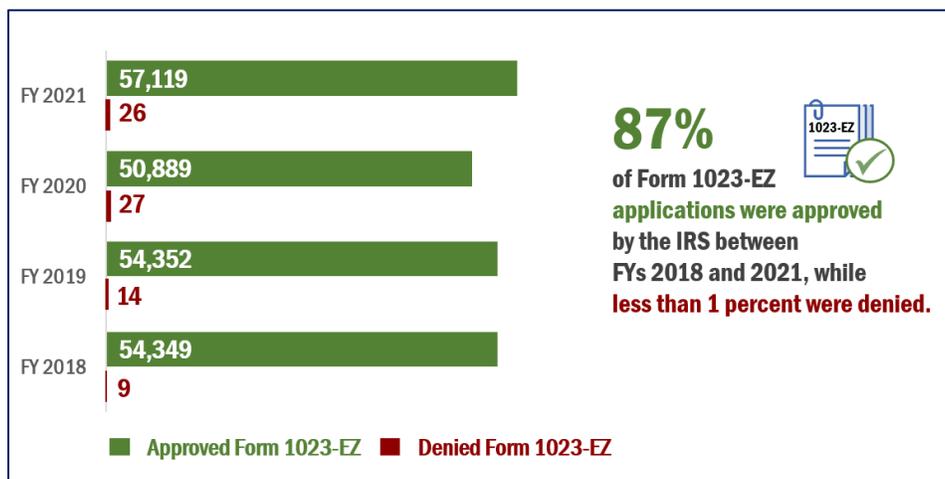
Source: The MITRE Corporation report and the Internal Revenue Manual.⁶

The IRS approved 101,220 (95 percent) of 106,218 Form 1023 applications filed and denied less than 1 percent between FYs 2018 and 2021.⁷ During the same time period, the IRS approved 87 percent of the 248,832 Form 1023-EZ applications, while denying less than 1 percent. The main reason for the differing approval rates for the two forms is the number of applications returned incomplete to the applicant. Specifically, between FYs 2018 and 2020, less than 1 percent of Forms 1023 were returned to the applicants as incomplete compared to approximately 11 percent of Forms 1023-EZ applications. Figure 4 summarizes the number of Form 1023-EZ applications approved and denied during FYs 2018 through 2021.

⁶ MITRE Report, *Assessment of Form 1023-EZ Sampling Methodology* (Mar. 2018) and Internal Revenue Manual 7.20.9 (September 28, 2021).

⁷ Applications can also be closed due to other reasons, such as returned incomplete, withdrawn by the applicant, and failure to establish (failure to respond to requests for additional information).

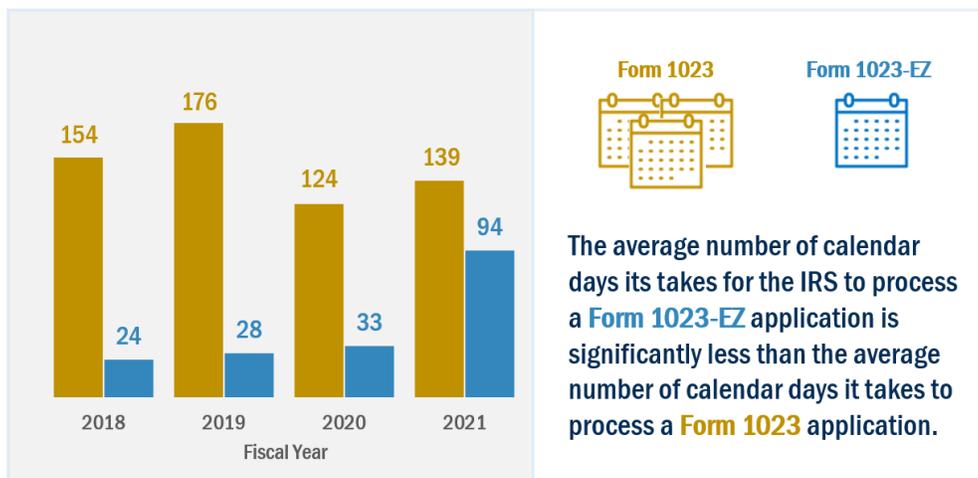
**Figure 4: Form 1023-EZ Application
Approved/Denied Closures for FYs 2018 Through 2021⁸**



Source: TIGTA analysis of Employee Plans/Exempt Organizations Determination System data.

The average number of calendar days it takes for the IRS to process a Form 1023-EZ application is significantly less than the average number of calendar days it takes to process a Form 1023 application for I.R.C. § 501(c)(3) tax-exempt status. Figure 5 shows the average number of calendar days to process Forms 1023 and 1023-EZ applications for FYs 2018 through 2021.

**Figure 5: Average Calendar Days to Process
Forms 1023 and 1023-EZ Applications for FYs 2018 Through 2021**



Source: TIGTA analysis of Employee Plans/Exempt Organizations Determination System data.

EO function management stated that an information technology outage in the first three quarters of FY 2021, an unexpected increase in Form 1023-EZ receipts, the reassignment of TEs to process Economic Impact Payments, and processing delays due to the Coronavirus

⁸ Figure 4 compares only Form 1023-EZ approved and denied closures.

Disease 2019 pandemic caused the extended processing times for Form 1023-EZ applications; however, the EO function has lowered processing times in FY 2022.⁹

Results of Review

Form 1023-EZ Does Not Require Sufficient Information to Make an Informed Decision and Does Not Educate Applicants About Tax-Exempt Status

Internal and external stakeholder opinions, States' reporting requirements, a comparison with the information required for Form 1023, our testing of the application process, results of the pre-determination reviews, and examination compliance efforts all showed that the information provided on Form 1023-EZ is insufficient to make an informed determination about tax-exempt status and does not educate applicants about eligibility.

Organizations recognized by the IRS as I.R.C. § 501(c)(3) organizations may be exempt from Federal income tax, and contributions to them may be tax deductible on the donors' tax returns. I.R.C. § 501(c)(3) requires an organization to be both "organized" and "operated" exclusively for exempt purposes set forth in the statute.¹⁰

To meet the organizational test, the organization's articles of organization must limit its purposes to one or more exempt purposes and must not empower the organization to engage, other than as an insubstantial part of its activities, in activities not in furtherance of exempt purposes.¹¹ If the articles state that the organization is formed for "charitable purposes," such articles ordinarily are sufficient for purposes of the organizational test.¹² To pass the operational test for tax-exempt status, a purported charitable organization must show that: 1) it engages primarily in activities which accomplish its exempt purpose, 2) its net earnings do not inure to the benefit of private shareholders or individuals, 3) it does not expend a substantial part of its resources attempting to influence legislation and does not participate or intervene in any political campaigns, and 4) it serves a public rather than a private interest.¹³ If the organization fails either the organizational test or the operational test, it is not exempt.

Although the IRS has developed timesaving procedures for processing Forms 1023-EZ, the application itself does not provide the IRS with sufficient information to appropriately approve or deny an organization's tax-exempt status. As a result, the IRS is approving organizations for tax-exempt status that may not qualify. For example, in May 2022, the Brooklyn District Attorney's Office indicted a man on charges of grand larceny, identity theft, and conducting a scheme to defraud by allegedly forming 23 fraudulent charitable entities and collecting at least \$152,000 in donations. Per our data analysis, the IRS approved 56 Forms 1023-EZ applications

⁹ Economic impact payments are tax credits authorized by the Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136, 134 Stat. 281 (codified as amended in scattered sections of 2, 5, 12, 15, 20, 21, 29, 42, and 45 U.S.C.).

¹⁰ These purposes are charitable, religious, educational, scientific, literary, testing for public safety, foster national or international amateur sports competition, and preventing cruelty to children or animals.

¹¹ Treas. Reg. § 1.501(c)(3)-1(b)(1)(i).

¹² Treas. Reg. § 1.501(c)(3)-1(b)(1)(ii).

¹³ Treas. Reg. § 1.501(c)(3)-1(c).

More Information Is Needed to Make Informed Decisions on Streamlined Applications for Tax Exemption

submitted by this individual in FYs 2019 and 2020, all with the same address. In addition, the Taxpayer Advocate Service (TAS) completed four studies between Calendar Years 2015 and 2019 of organizations for which the IRS approved their Form 1023-EZ applications and concluded that between 26 and 46 percent of the time, the approved organizations did not meet the organizational test and did not qualify for tax-exempt status.

Treasury regulations state that unless otherwise prescribed by applicable regulations or other guidance published in the Internal Revenue Bulletin, an organization must, in order to establish its exemption under I.R.C. § 501(c)(3), submit a detailed statement of its proposed activities with and as a part of its application for exemption.¹⁴ However, temporary Treasury regulations implemented in Calendar Year 2014 and later finalized in Calendar Year 2017 authorize the IRS to modify this requirement and rely on attestations by the organization that it meets I.R.C. § 501(c)(3) organizational and operational requirements.¹⁵ Therefore, the information required on Form 1023-EZ (attestations and activities narrative) meets the revised legal requirements for an organization to apply for and receive tax-exempt status.

TE/GE Division management told us that the IRS focuses on ensuring that applicants meet the operational test and not the organizational test because they believe the risks are higher that organizations will not be compliant with the operational test. Management stated that properly completing the organizing documents does not provide assurance that the organization will comply with all of the requirements. In addition, despite submitting organizing documents with their applications, examinations of organizations that filed Forms 1023 will sometimes later identify problems with the organizing documents. So, even if Form 1023-EZ filers were required to attach them to their applications, future examinations may still find problems with the organizing documents. In general, the IRS does not revoke the tax-exempt status when examinations find issues with the organizing documents.

Numerous internal and external stakeholders agree that a streamlined process is needed, but more information is required to make an informed decision on tax exemption

TAS, the National Association of State Charity Officials, the National Council on Nonprofits, and the Advisory Committee on Tax Exempt and Government Entities all agree that a more streamlined process is needed for smaller organizations to apply for I.R.C. § 501(c)(3) tax-exempt status; however, they also believe that the information currently required on Form 1023-EZ is insufficient to determine tax-exempt status.

In its FY 2011 report, TAS initially recommended that the IRS create a Form 1023-EZ for use by smaller organizations when applying for I.R.C. § 501(c)(3) tax-exempt status; however, TAS later stated that the approved Form 1023-EZ implemented in July 2014 went beyond what was envisioned and does not require enough information to make an informed decision on whether to grant tax-exempt status. TAS recommended in both its FYs 2015 and 2017 Annual Reports to Congress that, at the very least, the IRS should require Form 1023-EZ applicants to submit their organizing documents. TAS also recommended that applicants provide a description of their actual or planned activities and submit summary financial information such as past and projected revenues and expenses.

¹⁴ Treas. Reg. § 1.501(c)(3)-1(b)(1)(v).

¹⁵ Treasury Decision 9819.

More Information Is Needed to Make Informed Decisions on Streamlined Applications for Tax Exemption

In its response to the FY 2015 TAS recommendations, the IRS stated that a requirement for organizing documents would prevent electronic filing; however, filers of the longer Form 1023 have been required to file electronically since February 2020 and are required to attach organizing documents in order for the application to be accepted. The IRS also stated that, "review of organizing documents would increase case processing time, disrupting the efficiencies gained through the EZ process." Instead, "it continues to rely on pre- and post-determination reviews to identify potential compliance problems associated with the form."

In August of 2017, an EO function study of examinations of organizations that received tax-exempt status through filing the Form 1023-EZ between July and December of 2014 determined that 18 percent did not have proper organizing documents. The study went on to state that:

The Service needs to address the many organizations that filed the Form 1023-EZ making attestations and their governing documents are not adequate. However, they are out in the tax exempt sector operating, receiving charitable donations, grants, etc., but have not satisfied all of their organizational, operational and/or filing requirements. In the past, these flaws were ferreted out when the organizing documents were reviewed during the determination process.

In May 2014, the National Association of State Charity Officials submitted a letter to the IRS recommending the following information be required on Form 1023-EZ:

- Provision of articles and by-laws and requirements that organizations state where their purpose is in the organizing documents and greater specifics (beyond mere attestation) on provisions for distribution of assets upon dissolution.
- Detailed information regarding compensation and other financial arrangements with officers, directors, and key employees and other financial information, such as revenue and expenses.

In Calendar Year 2017, TAS stated in its Annual Report to Congress that it does not appear that the difficulty lies in identifying applications that need further review, but rather in designing an application that solicits enough information to allow the IRS to distinguish qualified applicants from those that do not qualify for I.R.C. § 501(c)(3) tax-exempt status. In its response to TAS, the IRS stated that requiring organizing documents does not reflect how the organization will operate, and how the organization operates is a determinative factor regarding tax-exempt status. TAS agreed that while that is true, "failing to meet the organizational test is the threshold factor and may have real consequences, even when the operational test is met. Organizations are required to meet the organizational test, and the IRS cannot carry out its oversight responsibility to ascertain whether the organizational test has been met without inspecting the organizing documents."

In January 2018, the IRS revised Form 1023-EZ to require a brief description of an organization's mission or most significant activities, limited to 250 characters. However, in April 2018, the National Council of Nonprofits issued a letter to the IRS recommending Form 1023-EZ be revoked and replaced with a streamlined form that continues to collect essential information that will better protect the public from scam artists and ensure that the IRS grants tax-exempt status only to eligible organizations. It went on to state that the abbreviated Form 1023-EZ eliminated so much information that the IRS can no longer make an informed decision about whether an applicant is eligible under existing statutory requirements.

More Information Is Needed to Make Informed Decisions on Streamlined Applications for Tax Exemption

TIGTA also interviewed 11 internal and external stakeholders, including regulators from five States and two practitioners, who advised us that the information required on Form 1023-EZ does not provide sufficient information to make a determination on granting an organization tax-exempt status. Many believed that the use of Form 1023-EZ increases the risk of ineligible organizations receiving tax-exempt status and affects the IRS's ability to enforce compliance. Although IRS forms are not designed for use by external stakeholders, State regulators stated that Form 1023-EZ has affected their compliance efforts because it eliminates barriers of entry and does not serve as a screening tool. In general, the stakeholders we interviewed believed there should be more information requirements added to Form 1023-EZ, starting with the organizing documents.

All 50 U.S. States generally require organizing documents from nonprofit organizations

TE/GE Division management stated that it would create increased taxpayer burden to require applicants to provide their organizing documents because applicants might have to convert them to the correct electronic format before attaching them. However, all 50 U.S. States, the District of Columbia, and Puerto Rico generally require the submission of organizing documents to establish nonprofit corporations within their respective jurisdictions.¹⁶ These organizations should have already submitted their organizing documents at the State level so there is minimal, if any, increased taxpayer burden to include them when filing their Form 1023-EZ applications.



TE/GE Division management also stated that attachments to the application would have to be manually downloaded from the third-party online filing website and uploaded to the IRS's application case management system. Although this would affect the IRS's application processing times and use of resources, the additional information is necessary to provide assurance that new tax-exempt entities are organized in accordance with the law and may help reduce the burden of future examinations of these entities.

In addition, the lack of an organizing document requirement could lead to the IRS approving tax-exempt status for organizations that do not meet statutory requirements. Without proper organizing documents, entities do not meet the organizational test requirements set forth in I.R.C. § 501(c)(3) and may inappropriately receive tax-exempt donations.

Form 1023 requires additional activities information

According to Treasury Regulations, in order for an organization to be exempt under I.R.C. § 501(c)(3), it must meet the operational test. An 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 I.R.C. § 501(c)(3). An organization

¹⁶ Other types of entities, such as unincorporated associations and trusts, may not be required to submit organizing documents to establish nonprofit status.

**More Information Is Needed to Make Informed
Decisions on Streamlined Applications for Tax Exemption**

will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.¹⁷

Form 1023 requires the inclusion of detailed activities information that allows the IRS to make informed decisions on tax-exempt status. This additional information helps the IRS ensure that the entity meets the operational test required by law. In contrast, the October 2018 revised Form 1023-EZ requires applicants to provide a brief description of the mission or most significant activities. Figure 6 shows the activities description section from Form 1023.

Figure 6: Form 1023 Activities Description

Form 1023 (Rev. 01-2020) Name: _____ EIN: _____ Page 4

Part IV Your Activities

1 Describe completely and in detail your past, present, and planned activities. Do not refer to or repeat the purposes in your organizing document. For each past, present, or planned activity, include information that answers the following questions:

- a. What is the activity?
- b. Who conducts the activity?
- c. Where is the activity conducted?
- d. What percentage of your total time is allocated to the activity?
- e. How is the activity funded (for example, donations, fees, etc.) and what percentage of your overall expenses is allocated to this activity?
- f. How does the activity further your exempt purposes?

Source: Form 1023.

In contrast, Figure 7 shows that Form 1023-EZ includes a different, less comprehensive activities section.

Figure 7: Form 1023-EZ Activities Description

Form 1023-EZ (Rev. 10-2018) Page 2

Part III Your Specific Activities

1 Briefly describe the organization's mission or most significant activities (limit 250 characters)

Source: Form 1023-EZ.

TE/GE Division personnel originally stated that requiring longer narratives and attachments to the application would result in the form no longer being an "EZ" form. Later, TE/GE Division management clarified that their goal was to establish a streamlined process that reduces taxpayer burden and improves tax administration in the context of still being able to make a determination (an "EZ" determination process). TIGTA agrees that additional requirements for filing Form 1023-EZ may increase burden and the time needed to review applications, but it would still be a streamlined process compared to a Form 1023 or even a Form 1023-EZ pre-determination review.

Although TE/GE Division management decided to focus on applicants' operations rather than also ensuring applicants meet organizational requirements, they require very little information on the Form 1023-EZ related to the activities of the applicants. In addition, requiring additional information when applying for tax-exempt status using Form 1023-EZ may be the only chance the IRS has to review an organization's activities because many of the smaller organizations will file a Form 990-N, *Electronic Notice (e-Postcard) for Tax-Exempt Organizations Not Required to File Form 990 or Form 990-EZ*, in the future and have little chance of being selected for an

¹⁷ Treas. Reg. § 1.501(c)(3)-1(c)(1).

More Information Is Needed to Make Informed Decisions on Streamlined Applications for Tax Exemption

examination.¹⁸ Insufficient activities information could lead to the IRS approving tax-exempt status for organizations that do not meet operational requirements set forth in I.R.C. § 501(c)(3).

The EO function approved fictitious organizations for tax exemption

To independently test the effectiveness of the application process and verify the concerns raised by stakeholders, we created five fictitious organizations and applied for tax-exempt status

In addition, we deliberately filed one of the applications with a mission that was ineligible for tax-exempt status.

The IRS approved all four applications claiming qualifying tax-exempt purposes. In addition, the EO function properly determined that the application with an ineligible mission may not qualify for tax-exempt status and assigned it to an RA for further review. Although the EO function appears to have followed procedures when processing TIGTA's fictitious Forms 1023-EZ, our tests of the standard application review process confirmed that not requiring organizing documents or detailed activities are significant procedural weaknesses, and substantiated the concerns raised by stakeholders. Requiring additional information, including organizing documents for Form 1023-EZ filers, may act as a deterrent and discourage dishonest individuals from establishing fictitious tax-exempt organizations and using them to perpetrate illegal activities. We recognize that entities can file fraudulent applications using the longer Form 1023 as it is not exclusively an issue with Form 1023-EZ filers. However, by not requiring any detailed

IRS Letter

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|  Department of the Treasury Internal Revenue Service Tax Exempt and Government Entities P.O. Box 2508 Cincinnati, OH 45201 | Date: 12/02/2021 |
| | Employer ID number: 35-2724093 |
| | Person to contact: Name: Customer Service ID number: 31954 Telephone: 877-829-5500 |
| | Accounting period ending: December 31 |
| | Public charity status: 170(b)(1)(A)(vi) |
| | Form 990 / 990-EZ / 990-N required: Yes |
| | Effective date of exemption: June 1, 2021 |
| | Contribution deductibility: Yes |
| | Addendum applies: No |
| | DLN: 26053656006691 |

PROJECT PROM DC
600 PENNSYLVANIA AVE SE 15590
WASHINGTON, DC 20003

Dear Applicant:

We're pleased to tell you we determined you're exempt from federal income tax under Internal Revenue Code (IRC) Section 501(c)(3). Donors can deduct contributions they make to you under IRC Section 170. You're also qualified to receive tax deductible bequests, devises, transfers or gifts under Section 2055, 2106, or 2522. This letter could help resolve questions on your exempt status. Please keep it for your records.

Organizations exempt under IRC Section 501(c)(3) are further classified as either public charities or private foundations. We determined you're a public charity under the IRC Section listed at the top of this letter.

If we indicated at the top of this letter that you're required to file Form 990/990-EZ/990-N, our records show you're required to file an annual information return (Form 990 or Form 990-EZ) or electronic notice (Form 990-N, the e-Postcard). If you don't file a required return or notice for three consecutive years, your exempt status will be automatically revoked.

If we indicated at the top of this letter that an addendum applies, the enclosed addendum is an integral part of this letter.

For important information about your responsibilities as a tax-exempt organization, go to www.irs.gov/charities. Enter "4221-PC" in the search bar to view Publication 4221-PC, Compliance Guide for 501(c)(3) Public Charities, which describes your recordkeeping, reporting, and disclosure requirements.

Sincerely,

Stephen A. Martin
Director, Exempt Organizations
Rulings and Agreements

¹⁸ A Form 990-N is the annual filing for small organizations with annual gross receipts of \$50,000 or less and includes limited information such as organization name, Employer Identification Number, and tax year. IRS records show that less than 1 percent of organizations that filed Form 1023-EZ are selected for examination.

More Information Is Needed to Make Informed Decisions on Streamlined Applications for Tax Exemption

information when filing the short form, there are fewer barriers to creating a fictitious organization and obtaining tax-exempt status. TE/GE Division management stated that people can lie on applications regardless of which form is used, so requiring additional information for Form 1023-EZ filers does not prevent them from filing fictitious applications.

[REDACTED]

After the IRS approved our four requests for tax-exempt status, it included them on the list of approved organizations that can receive tax deductible contributions (IRS Publication 78, *Cumulative List of Organizations*). The IRS informs taxpayers that they may rely on this list for making a donation to ensure that they can legally include them as a charitable deduction on their tax returns.

The ease with which individuals can apply for and receive tax-exempt status using the Form 1023-EZ streamlined application demonstrates the importance of requiring more detailed information during the application process. These weaknesses, coupled with the fact that less than 1 percent of tax-exempt organizations are examined each year, increases the risk of fraudulent or ineligible organizations receiving tax-exempt status and operating with little chance of detection. Insufficient information required on Form 1023-EZ may result in the IRS granting tax-exempt status to organizations that do not meet I.R.C. § 501(c)(3) legal requirements, including fictitious organizations that may potentially commit illegal acts, such as preying on unsuspecting taxpayers for donations or funding terrorist organizations. IRS application review procedures do include searching the Department of the Treasury's Office of Foreign Assets Control Specially Designated Nationals and Blocked Persons List for names and addresses included on the application. This list include persons (individuals and entities) identified as being associated with terrorism.

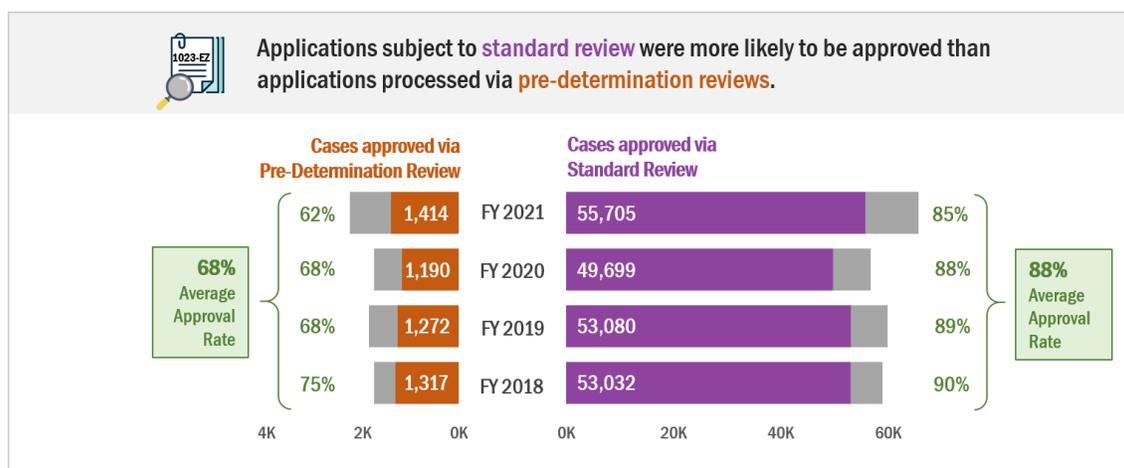
Using charitable entities to potentially fund terrorist organizations is of such concern that the Department of the Treasury includes *Protecting Charitable Organizations* as part of its Terrorism and Illicit Finance policy issue. It states, "Protecting charities from terrorist abuse is a critical component of the global fight on terrorism.... Terrorists have exploited the charitable sector to raise and move funds, provide logistical support, encourage terrorism recruitment, or otherwise support terrorist organizations and operations. This abuse threatens to undermine donor confidence and jeopardizes the integrity of the charitable sector."

Applications subject to pre-determination reviews were approximately three times more likely to not be approved for tax-exempt status

All Form 1023-EZ applications submitted are either assigned for standard review or selected for a pre-determination review. Pre-determination reviews include contacting the applicant for additional information, such as its organizing documents if they cannot be located online via the applicable State website. Each application has a 3 percent chance to be randomly selected for a pre-determination review. Figure 8 compares the results of pre-determination reviews with those of standard reviews from FYs 2018 through 2021.

**More Information Is Needed to Make Informed
Decisions on Streamlined Applications for Tax Exemption**

Figure 8: Form 1023-EZ Applications Approved for FYs 2018 Through 2021¹⁹



Source: TIGTA analysis of Employee Plans/Exempt Organizations Determination System data.

Applications subject to pre-determination reviews were about three times more likely to not be approved than applications processed via the standard review.²⁰ Following the standard review process, approximately one in every 10 applications was not approved over the four-year period. However, when the pre-determination process was followed, the EO function did not approve approximately three in every 10 applications.

The IRS contracted with a research firm to assess the Form 1023-EZ process. In March 2018, the research firm provided its findings in a report to the IRS stating it did not find evidence that requiring current Form 1023-EZ filers to file the long Form 1023 would lower the approval rate or increase the denial rate. However, it did find that, “Form 1023-EZ applications randomly sampled for the more rigorous pre-determination review process have a lower approval rate and a higher denial rate than applications processed with the standard level of review.” The research firm’s report also stated that the higher number of applicants identified in pre-determination reviews versus standard reviews as ineligible for exemption under I.R.C. § 501(c)(3) highlights the need for future research into determination factors identified in the pre-determination process that are not identified in the standard review process.

In addition, the IRS could improve customer service if it better communicated with applicants about the status of their requests. If an application is randomly selected for a pre-determination review or referred to an RA for further development, the EO function does not notify the organization about the additional time needed to process its application. Instead, the IRS’s website instructs the applicant to contact the IRS by telephone, fax, or mail to check on the application’s status if it was submitted prior to the application dates that the website indicates the EO function is currently processing. This requirement increases taxpayer burden, as it requires the applicants to proactively check on the status of their applications and then contact the IRS for an update, which can be a challenge because the IRS answered less than 22 percent of incoming telephone calls during FY 2021. For example, it took us five attempts and more than two hours of hold time to reach a customer service representative to obtain the status of

¹⁹ Standard review includes cases that were referred to an RA for further development.

²⁰ Applications that are not approved can be closed for several reasons, including the application was returned incomplete, the organization did not qualify to file Form 1023-EZ, or the organization did not respond to an information request. The organizations may qualify for tax-exempt status, but did not prove it with their applications.

our application with the questionable mission. Furthermore, we had to select the other questions and application status option for a different TE/GE Division function (rather than the EO function) in order to speak with someone because the option for EO application status was unable to take calls due to extremely high call volume.

The IRS relies on a post-determination Form 1023-EZ examination strategy to detect noncompliance; however, few organizations are examined

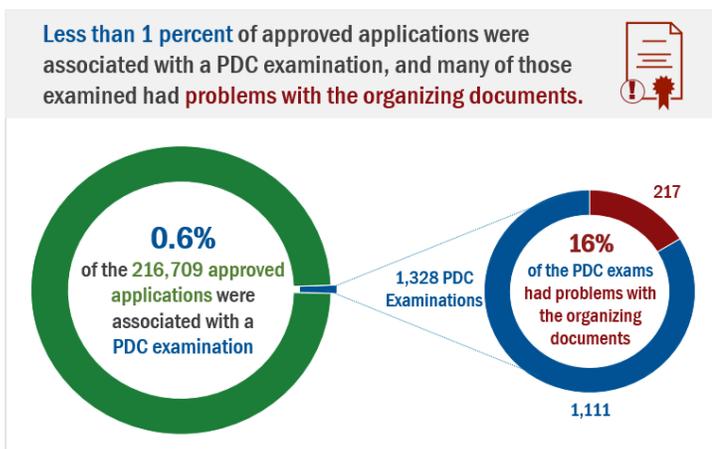
In January 2016, the Examinations unit began a Post-Determination Compliance (PDC) program for Form 1023-EZ applicants and started conducting correspondence audits for a sample of the organizations for which the IRS approved tax-exempt status. The IRS relies on the PDC examination process as a risk mitigation tool to assess compliance and to evaluate whether organizations meet the criteria that they attested to on their Form 1023-EZ applications.

Post-determination examinations provide limited compliance oversight of Form 1023-EZ filers' approved tax-exempt status. In its FY 2017 Annual Report to Congress, TAS stated:

Instead of addressing compliance concerns upfront when the organization is applying for recognition of its exempt status, the IRS says it will audit itself out of a problem entirely of its own making. And it is not doing that either, as the IRS audits less than one percent of tax-exempt entities every year.

For FYs 2018 through 2021, the IRS completed 1,328 PDC examinations of Form 1023-EZ filers, which represents 0.6 percent of the 216,709 applications approved over the same period.²¹

Furthermore, examiners indicated that 217 (16 percent) of the 1,328 PDC examination cases had problems with the organizing documents, meaning these organizations may have been operating without meeting the organizational requirements for tax-exempt status. Obtaining the organizing documents during the application process could have potentially identified these problems before the IRS approved the tax exemption for these organizations.



In contrast, examinations of returns filed by Form 1023 applicants from FYs 2014 through 2019 identified problems with the organizing documents in 6 percent of the cases. Figure 9 compares the examination results for Forms 1023 and 1023-EZ filers from FYs 2014 through 2019.

²¹ Examination information obtained from the Returns Inventory Classification System. This system allows access to tax data related to filing, processing, and posting of returns and also provides automatic sampling, criteria for audits, and the tracking of audit results.

**Figure 9: Comparison of Form 1023 Filers' Examinations Results With
Form 1023-EZ Filers' Examinations Results – FYs 2014 Through 2019²²**

| Closing Type | Form 1023 Examinations Percentage | Form 1023-EZ Examinations Percentage |
|-----------------------------|--------------------------------------|---|
| No Change | 40% | 34% |
| Organizing Document Issue | 6% | 16% |
| Agreed Tax Penalty/Change | 11% | 1% |
| Unagreed Tax/Penalty Change | 4% | 1% |
| Revocations | 2% | 4% |

Source: PDC presentation – March 18, 2021.

Overall, examiners identified fewer issues with returns filed by Form 1023 filers than Form 1023-EZ filers based on the no change rates.²³ In addition, Form 1023-EZ filers' examinations resulted in revocations of tax-exempt status 4 percent of the time while Form 1023 filers' examinations were closed as revocations 2 percent of the time. However, examiners identify tax and penalty changes more often when examining Form 1023 filer returns than Form 1023-EZ filer returns; most likely because Form 1023 filers are larger organizations with more complex operations.

Form 1023-EZ lacks an educational component

The lack of detailed questions about the applicant's organizational and operational plans on the Form 1023-EZ eliminates the inherent educational benefits these questions provide. External stakeholders have expressed concerns regarding the loss of the educational component with the use of Form 1023-EZ. In its Calendar Year 2012 report, the Advisory Committee on Tax Exempt and Government Entities explained that the detailed Form 1023 questions force the organizations to learn the requirements to obtain and maintain tax-exempt status. The report also recommended against the development of Form 1023-EZ because:

Form 1023 serves an important educational purpose for applying organizations. Through its questions, the Form 1023 forces the applying organization to think somewhat deeply about its activities, finances, and management. The Form 1023 also signals to the organization that it is entering into a (probably unfamiliar) comprehensive regulatory regime, and working through the questions on the form provides the organization with a great deal of information about compliance with this regime. We agree with the many practitioners we spoke with who believe that the educational benefits of Form 1023 are especially important for small organizations.

In its FY 2011 Annual Report to Congress, TAS recommended that the IRS develop a Form 1023-EZ to lessen taxpayer burden without depriving the IRS of any information it currently tracks or uses, and the IRS disagreed stating that, "Form 1023 serves an educational

²² Examinations can be closed with other closing types, such as termination and delinquent return secured.

²³ The no change rate is the percentage of examinations for which the examiner closed the case with no recommended tax change.

More Information Is Needed to Make Informed Decisions on Streamlined Applications for Tax Exemption

purpose because it provides applicants either an introductory or a refresher course on the rules for tax exemption.” However, in June 2013, the EO function began a Lean Six Sigma project to identify areas to make the application process more efficient due to the increasing inventory backlog of applications for tax-exempt status.²⁴ In July 2014, the IRS began addressing the backlog by allowing small organizations to use the new Form 1023-EZ.

We asked TE/GE Division management why they changed their position about the educational benefits of Form 1023 and if they are providing any education to Form 1023-EZ filers. Management stated that IRS.gov, StayExempt.IRS.gov, and Pay.gov²⁵ provide organizations with the necessary education to apply for and maintain tax-exempt status.²⁶ In addition, the instructions for completing the Form 1023-EZ also educate applicants. They include a discussion on the legal requirements for tax exemption and refers the reader to other publications. The IRS has also updated and added online educational resources, such as the *File Error-Free Form 1023-EZ Webinar*, and embedded tips when filling out the application on Pay.gov. However, some online educational resources were already available to organizations when the IRS disagreed with TAS’s recommendation for a simpler form.

In addition, TIGTA reviewed the statistics related to the use of the IRS’s web pages and determined that online information may not be used to its full educational potential by Form 1023-EZ filers. We cannot determine how many viewers were potential applicants or existing charities searching for assistance versus researchers, students, or people who decided not to apply. In addition, although we cannot determine which application those viewers who did subsequently apply used, the majority of new I.R.C. § 501(c)(3) organizations file Form 1023-EZ when applying.

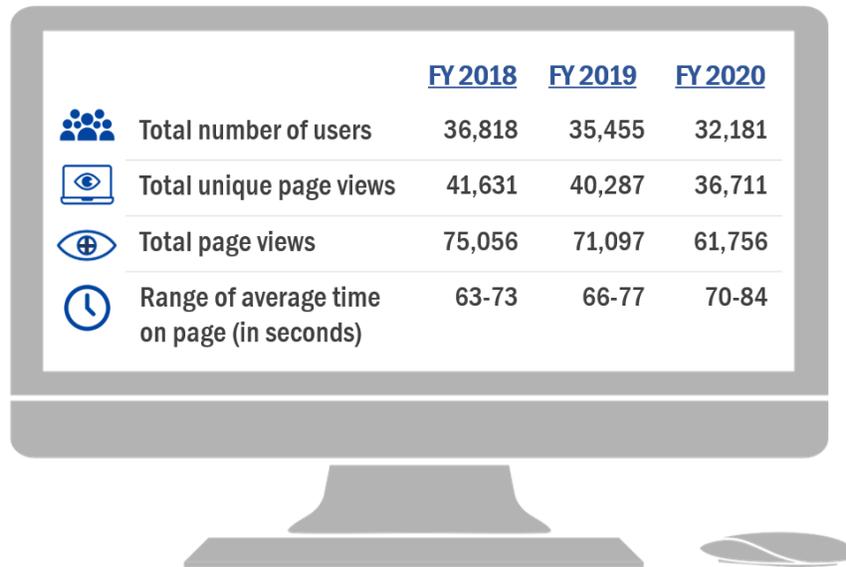
IRS.gov – Figures 10 and 11 show that since the implementation of the revised Form 1023-EZ in FY 2018, the use of educational information related to applying for I.R.C. § 501(c)(3) tax-exempt status, such as life cycle of a public charity, application process, and exemption requirements for I.R.C. § 501(c)(3) organizations, has generally decreased through FY 2020.

²⁴ Lean Six Sigma is a business strategy to improve processes. Lean refers to cutting waste and nonproductive activities, avoiding duplication, and streamlining a business process flow. Six Sigma is a method to measure and increase efficiency. The TE/GE Division uses this strategy to review current processes and find ways to do them better.

²⁵ Pay.gov is the online web page an organization must use to submit the Form 1023-EZ application and payment to the IRS. It includes educational links to assist applicants that apply using Form 1023-EZ.

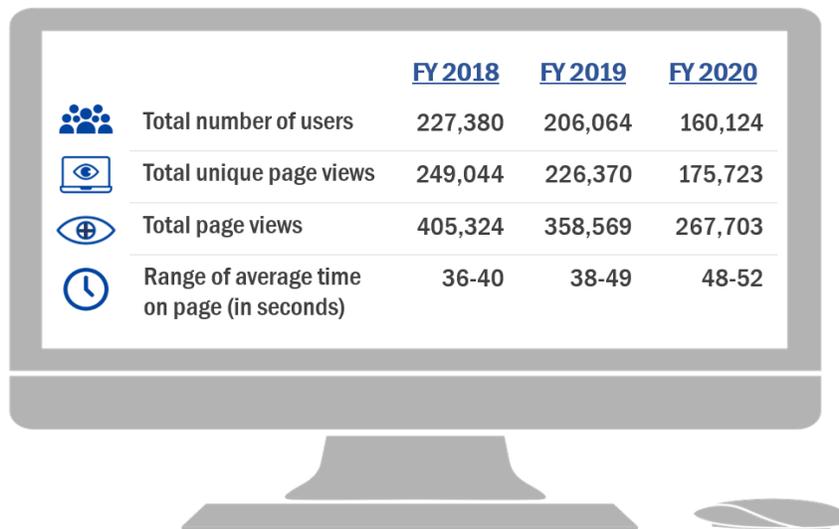
²⁶ “Stay Exempt” is a series of dynamic and comprehensive tax courses designed to assist tax-exempt organizations with the application process and to ensure that organizations understand what they should do to maintain exempt status and what actions may put their exemption in jeopardy.

Figure 10: Charities' and Nonprofits' Life Cycle of a Public Charity²⁷



Source: IRS.gov web data analytics.

Figure 11: Charities' and Nonprofits' Application Process²⁸



Source: IRS.gov web data analytics.

Stay Exempt – Since the IRS began collecting statistics in February 2015, the number of page views of the Stay Exempt website and its courses has generally increased. For example, the average unique page views for the course titled, *Applying for Section 501(c)(3) Status*, is consistent with the total Form 1023-EZ applications for FYs 2018 through 2020. However, the unique page views for the course titled, *Maintaining 501(c)(3) Tax-Exempt Status*, is significantly

²⁷ The data are based on monthly averages for each fiscal year.

²⁸ The data are based on monthly averages for each fiscal year.

More Information Is Needed to Make Informed Decisions on Streamlined Applications for Tax Exemption

less than the total Form 1023-EZ applications for FYs 2018 through 2020. This suggests that tax-exempt organizations may not be using the available information fully to ensure that they stay compliant, although we cannot determine how many viewers of the educational materials were actual I.R.C. § 501(c)(3) exempt organizations. As a result, these new organizations might not understand the requirements for maintaining their tax-exempt status. In addition, the average time spent viewing the educational courses related to applying for and maintaining I.R.C. § 501(c)(3) tax-exempt status is significantly less than the total length of the courses. For example, the *Applying for Section 501(c)(3) Status* course is almost 40 minutes long, but the average time spent on that page was under five minutes.

The Commissioner, TE/GE Division, should:

Recommendation 1: Revise the activities description narrative on Form 1023-EZ to match Form 1023 to help applicants understand the requirements and provide the IRS with more information to make a determination.

Management's Response: The IRS disagreed with this recommendation. Form 1023-EZ elicits information sufficient for small charities that meet certain eligibility requirements. While Form 1023-EZ now has space for a brief narrative description of exempt activities, the "long" Form 1023 elicits a more extensive narrative. While the IRS shares a concern for the integrity of the tax-exempt sector, it is unclear that an increase in paperwork would yield corresponding compliance, especially when applications for exemption are necessarily prospective.

Office of Audit Comment: The report shows that Form 1023-EZ applications subjected to the more in-depth pre-determination reviews were three times more likely not to be approved than Form 1023-EZ applications processed via the standard review. Furthermore, applications for tax-exempt status are prospective regardless of whether they are made via Form 1023 or Form 1023-EZ. Requiring organizations to provide more details about their activities may act as a deterrent to filing fictitious applications or, at the very least, educate the organizations about what activities are allowed under the law.

Recommendation 2: Assess the feasibility of requiring applicants to submit their organizing documents as an attachment to Form 1023-EZ.

Management's Response: The IRS agreed with this recommendation and plans to assess the feasibility of requiring applicants to submit organizational documents as an attachment to Form 1023-EZ with a consideration of the burden and impact of such a requirement. This consideration will require the IRS to balance the burden on small applicants, the additional time it will take for the tax examiners to review the Forms 1023-EZ, and the need for additional tax examiner resources against the impact, if any, on whether the applicant operates as a charity after it has received a favorable determination letter.

Office of Audit Comment: Although management agreed with the recommendation, they made some statements that we believe warrant additional comment. See Appendix IV for further details.

More Information Is Needed to Make Informed Decisions on Streamlined Applications for Tax Exemption

Recommendation 3: Notify applicants when additional time is needed to process their Form 1023-EZ applications, either due to being selected for a pre-determination review or because the application requires additional review prior to a determination decision.

Management’s Response: The IRS will consider this but noted that it already makes available on IRS.gov information regarding the status and timing of exemption applications. On the “Where’s My Exemption Application” web page, taxpayers can find information explaining what happens after the application is submitted and benchmarks based on the submission date for whether the application has been assigned for review. Under current procedures, organizations in these situations will receive correspondence from the IRS requesting additional information and therefore will be aware of the status of their application. Requiring the IRS to send additional correspondence in instances in which the application is subject to pre-determination or other review would therefore be redundant, consuming resources that otherwise would be available to process cases and handle other taxpayer correspondence.

Office of Audit Comment: The *Omnibus Taxpayer Bill of Rights* includes the right to be informed of IRS decisions and to receive clear explanations of the outcomes.²⁹ Taxpayers also have the right to receive prompt assistance and to clear and easily understandable communications from the IRS. However, Forms 1023-EZ subjected to the pre-determinations and referral processes can take significantly longer to review than applications reviewed by the TEs following the standard review process. In FY 2020, the RAs took on average 104 calendar days to process pre-determinations and referral cases; meanwhile, the TEs processed standard review cases in an average of 27 calendar days. These longer review processes result in taxpayers potentially waiting months before hearing anything from the IRS regarding their streamlined applications. For example, we submitted our test case application that required additional review in September 2021. We did not receive correspondence from the IRS requesting additional information until March 2022, six months later. Taxpayers are instructed to contact the IRS to inquire about the status of their applications if it is past the benchmark dates that are shown on the “Where’s My Exemption Application” web page. However, in FY 2021, the IRS answered just 22 percent of telephone calls, so taxpayers may be denied their right to be informed.

Online Guidance for Form 1023-EZ Is Inaccurate

Pay.gov, the online web page used to apply for tax-exempt status, includes educational links to assist applicants who apply using Form 1023-EZ.³⁰ However, one of the educational links takes users to the IRS’s web pages on *Charities and Nonprofits* and the *Application Process*, which may cause confusion and discourage organizations from applying for tax-exempt status using Form 1023-EZ due to inaccurate information.

The IRS website’s *Application Process* page is a step-by-step analysis of an organization’s eligibility to apply for recognition of exemption from Federal income taxation that includes

²⁹ Pub. L. No. 100-647, 102 Stat. 3730 (1988) (codified as amended in scattered sections of 5 and 26 U.S.C.).

³⁰ Pay.gov is a website of the Department of the Treasury, Bureau of the Fiscal Service.

**More Information Is Needed to Make Informed
Decisions on Streamlined Applications for Tax Exemption**

qualification questions. However, many of the questions relate to the requirements for the Form 1023 application, which are not the same as the Form 1023-EZ and do not address the applicant's eligibility to use the simpler form. For example, one question asks:

New organizations must give financial statements for the current year and proposed budgets for the next two years, including a detailed breakdown of revenue and expenses. A section 501(c)(3) organization provides this information on Part VI, Form 1023. Have you included this financial information?

If the applicant answers "No" to this question, the website states that they are not eligible for exemption. However, Form 1023-EZ filers are not required to provide financial statements or budgets with their applications. The IRS did not update this educational information to accurately reflect the requirements for filing Form 1023-EZ. Although improvements are needed to Form 1023-EZ, eligible filers may needlessly file the longer Form 1023, resulting in unnecessary burden and higher application fees.

Recommendation 4: The Commissioner, TE/GE Division, should update the IRS's *Charities and Nonprofits* website page with accurate information on the application process for Form 1023-EZ filers.

Management's Response: The IRS agreed with this recommendation, stating that the TE/GE Division will update the Application Process web page to include the requirements for filing Form 1023-EZ.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this audit was to assess the efficiency of the streamlined application process for recognition of tax-exempt status under I.R.C. § 501(c)(3), including 1) whether the application provides the IRS with sufficient information to approve or deny the organization for tax-exempt status, and 2) the use of resources and processing times in making determinations. To accomplish our objective, we:

- Evaluated the information required on Form 1023-EZ, and whether the application provides the IRS with sufficient information to approve or deny the organization for tax-exempt status.
- Analyzed Employee Plans/Exempt Organizations Determination System data to determine application outcomes and processing times for Forms 1023 and 1023-EZ standard and pre-determination review cases.
- Evaluated the EO function's Examinations unit case results for Form 1023-EZ PDC examination cases.
- Obtained internal and external stakeholder opinions on whether the information required on Form 1023-EZ provides the IRS sufficient information to make a determination on granting an organization tax-exempt status, and whether the use of Form 1023-EZ increases the risk of ineligible organizations receiving tax-exempt status.
- Analyzed IRS website data analytics to determine taxpayers' use of online educational information related to applying and keeping I.R.C. § 501(c)(3) tax-exempt status since the implementation of the Form 1023-EZ.
- Compared the registration requirements for U.S. States that require their own application filing for nonprofits to the information required on the IRS's Form 1023-EZ to determine what additional information would be useful to the IRS in determining tax-exempt status and detecting potential future noncompliance.

Performance of This Review

This review was performed with information obtained from the EO function's Determinations unit in Cincinnati, Ohio; the Examinations unit in Brooklyn, New York; and PDC examination data obtained from the Compliance Planning and Classification function located in Dallas, Texas, during the period April 2021 through June 2022. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Major contributors to the report were Heather Hill, Assistant Inspector General for Audit (Management Services and Exempt Organizations); Bryce Kisler, Acting Assistant Inspector General for Audit (Management Services and Exempt Organizations); Carl Aley, Director;

Cheryl Medina, Audit Manager; Jennifer Burgess, Lead Auditor; Beth Golden, Senior Auditor; and Vikram Singh, Auditor.

Validity and Reliability of Data From Computer-Based Systems

We obtained Form 1023-EZ application data from IRS data extracts of the Employee Plans/Exempt Organizations Determination System and Examinations unit data from IRS data extracts of the Returns Inventory Classification System. We performed tests to assess the reliability of data from both systems. We evaluated the data by 1) performing electronic testing of required data elements, 2) reviewing existing information about the data and the system that produced them, and 3) interviewing agency officials knowledgeable about the data. We determined that the data were sufficiently reliable for purposes of this report.

Internal Controls Methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: the EO function's policies, procedures, and practices for processing and examining Form 1023-EZ applications. We evaluated these controls by reviewing source documents, interviewing TE/GE Division management and employees, and conducting data analyses.

Appendix II

Form 1023-EZ Application Review Process

All Form 1023-EZ applications are submitted electronically and either assigned to a TE for standard review or selected for a pre-determination review by an RA. Each application has a 3 percent chance of being randomly selected for a pre-determination review. Applications not selected for a pre-determination review are assigned to general case processing.

General Case Processing

General case processing is the standard review performed by the TEs to process Form 1023-EZ applications. The TE will only use information provided on the application or information that is already part of IRS records. The TEs do not contact the applicant or conduct Internet research. This review generally consists of the following steps:

- *Comprehensive List of Terrorists and Groups Check:* If the organization is a potential match to an entity, person, or address on this list, the case enters the TE referral case work stream (explained below).
- *Entity Identification Check:* The TE will compare the name, address, and EIN provided on the application with IRS records in the Integrated Data Retrieval System and attempt to resolve any discrepancies.¹ If the EIN on the application is not in IRS records and the correct EIN cannot be determined, the application is returned incomplete.
- *Application Completeness Check:* If any of the required fields on the application are incomplete or the user fee is insufficient or did not process, the application will be returned incomplete.
- *Appropriate National Taxonomy of Exempt Entities Code Check:* If the National Taxonomy of Exempt Entities code on the application does not generally describe an organization exempt under I.R.C. § 501(c)(3), the TE will request specialist involvement (explained below).²
- *Exemption and Application Status Check:* The TE will research IRS data to identify any current or previous applications or exempt statuses. Generally, if the organization is already exempt under I.R.C. § 501(c)(3), the TE informs the organization and closes the case. If the organization is already or was previously exempt under a different subsection, the TE returns the Form 1023-EZ incomplete.
- *Eligible Organizational Structure Check:* If "LLC" is part of the organization's name or the Integrated Data Retrieval System indicates the organization is formed as a for-profit entity, the TE will request specialist involvement.
- *Activities Narrative:* The TE will review the activity description to determine if the organization's mission and activities are within the scope of I.R.C. § 501(c)(3). If an

¹ IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

² A National Taxonomy of Exempt Entities code is a three-character series of letters and numbers that generally summarize an organization's purpose.

More Information Is Needed to Make Informed Decisions on Streamlined Applications for Tax Exemption

applicant's narrative is incomplete, the application may be rejected or referred for specialist involvement.

If the TE completes the review steps and the application is not returned incomplete or referred to a specialist, the application will be approved.

Specialist Involvement: If during the general case review process, the TE identifies one or more issues requiring the advice of an RA, the TE will request specialist involvement. The RA will conduct research on the Integrated Data Retrieval System and/or the Internet and advise the TE how to proceed with the case. That advice will fall into one of the following categories: continue processing the case, return the application incomplete, or send the case to be worked by an RA as a TE referral. The RA does not contact the organization as part of the specialist involvement.

TE Referral: If either the TE or the RA determines that a case needs further development, the TE transfers it as a TE referral case. An RA will review the referral issues, perform research, and request additional information from the organization as needed to make a determination.

Pre-Determination Review and TE Referral Cases

Applications selected for pre-determination review and TE referral cases are worked by the RAs. In addition to the general case processing procedures, the RAs will perform additional research of the Integrated Data Retrieval System, the relevant Secretary of State's website, and the organization's website. The RAs will also request additional information from the organization as needed to make a determination such as organizing documents, description of activities, and financial information. Based on this more detailed review, the application will be approved, disapproved, returned incomplete, or withdrawn by the applicant.

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

September 22, 2022

MEMORANDUM FOR HEATHER M. HILL
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Sunita B. Lough Sunita B. Lough Digitally signed by Sunita B. Lough
Date: 2022.09.22 12:07:42 -04'00'
Commissioner,
Tax-Exempt and Government Entities Division (TE/GE)

SUBJECT: Draft Report – More Information Is Needed to Make Informed
Decisions on Streamlined Applications for Tax Exemption
(Audit # 202110017)

Thank you for the opportunity to review your draft report titled: “More Information Is Needed to Make Informed Decisions on Streamlined Applications for Tax Exemption”. By reducing processing time, Form 1023-EZ (Streamlined Application for Recognition of Exemption Under Section 501(c)(3)) reduces paperwork burden on small charities while freeing IRS resources for complex applications and examinations.

Form 1023-EZ elicits information sufficient for small charities that meet certain eligibility requirements. While Form 1023-EZ now has space for a brief narrative description of exempt activities, the “long” Form 1023 (Application for Recognition of Exemption Under Section 501(c)(3)) elicits a more extensive narrative. The draft report recommends conforming the narrative length on the EZ form to that on the “long” form. While we share a concern for the integrity of the tax-exempt sector, it’s unclear that an increase in paperwork would yield corresponding compliance, especially when applications for exemption are necessarily prospective.

The IRS determines whether an organization qualifies for exemption under section 501(c)(3) “based solely upon the facts, attestations, and representations contained in the administrative record.” Sec. 3.05 of Rev. Proc. 2022-5, 2022-1 I.R.B. 256. Organizational documents are often based upon pro forma drafting to permit the organization to develop and expand its exempt activities within allowable parameters. Prior to the implementation of Form 1023-EZ, IRS’ Exempt Organization Determination staff did not approve the exemption of an organization until the applicant perfected its organizational documents. This added weeks to the application process. Now we accept the applicant’s attestation that the organizational documents meet the requirements under the law.

More Information Is Needed to Make Informed Decisions on Streamlined Applications for Tax Exemption

2

During an examination of an existing exempt organization, examiners may find that an organizing document does not comply with the law. However, this documentary

noncompliance has generally not been a reason to revoke the organization's exempt status. If the organization substantially complies with the operational requirements and is operated for exempt purposes, the documentary requirement is generally cured through amendment.

Since January 2020, the IRS has required the Form 1023, like the Form 1023-EZ, to be submitted electronically through Pay.gov. When the electronic Form 1023 was implemented, attachments to the Form 1023 were required to be submitted with the application through Pay.gov. Based on our experience with the Form 1023, we will consider requiring organizational documents with the Forms 1023-EZ. This consideration will require us to balance the burden on small applicants, the additional time it will take for the tax examiners to review the Forms 1023-EZ, and the need for additional tax examiner resources, against the impact, if any, on whether the applicant operates as a charity after it has received a favorable determination letter.

The draft report asserts that streamlining "increases the risk of fraudulent or ineligible organizations receiving tax-exempt status". However, the data referenced in the report do not show an increase in fraudulent applications since 2014, before which all applicants used the long Form 1023. The draft report compares examinations of organizations that received exemption using Forms 1023-EZ and 1023. The report highlights fewer issues in the case of Forms 1023 based on the "No Change" rate. However, 27% and 41% of Form 1023 and Form 1023-EZ cases respectively resulted in a written advisory rather than a revocation or tax assessed on the organization. Written advisories are used to educate or advise the organization of actions that could, in the future, result in revocation or tax if the organization does not make the appropriate change. Taking into account this relevant data results in "No Change" rates of 67% and 75% for Forms 1023 and 1023-EZ, respectively.

As we continuously strive to improve processes, as stated above, the IRS will consider a requirement to submit organizational documents as an attachment to Form 1023-EZ. We value stakeholder input and continue to balance the efficient and timely processing of applications, the burdens on small organizations, and the risks of noncompliance in the determination process.

We appreciate the opportunity to review and comment on the draft report. Attached is a detailed response to your recommendations. If you have any questions, please contact me, or your staff may contact Rob Malone, Director, Exempt Organizations/Government Entities (EO/GE), TE/GE, at Robert.Malone@irs.gov.

Attachment

**More Information Is Needed to Make Informed
Decisions on Streamlined Applications for Tax Exemption**

Attachment

**Corrective Actions for TIGTA Audit Draft Report –
More Information Is Needed to Make Informed Decisions on Streamlined
Applications for Tax Exemption (Audit #202110017)**

RECOMMENDATION 1:

The Commissioner, TE/GE Division, should: Revise the activities description narrative on Form 1023-EZ to match Form 1023 to help applicants understand the requirements and provide the IRS with more information to make a determination.

CORRECTIVE ACTION:

The IRS does not support this recommendation. It's unclear that a paperwork increase would yield corresponding compliance.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL(S):

N/A

CORRECTIVE ACTION MONITORING PLAN:

N/A

RECOMMENDATION 2:

The Commissioner, TE/GE Division, should: Assess the feasibility of requiring applicants to submit their organizing documents as an attachment to Form 1023-EZ.

CORRECTIVE ACTION:

The IRS will assess the feasibility of requiring applicants to submit organizational documents as an attachment to Form 1023-EZ with a consideration of the burden and impact of such a requirement.

IMPLEMENTATION DATE:

March 15, 2023

RESPONSIBLE OFFICIAL(S):

Director, EO/GE, TE/GE

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.

**More Information Is Needed to Make Informed
Decisions on Streamlined Applications for Tax Exemption**

2

RECOMMENDATION 3:

The Commissioner, TE/GE Division, should: Notify applicants when additional time is needed to process their Form 1023-EZ applications, either due to being selected for a pre-determination review or because the application requires additional review prior to a determination decision.

CORRECTIVE ACTION:

The IRS will consider this. However, we should note the IRS already makes available on IRS.gov information regarding the status and timing of exemption applications. On the "Where's My Exemption Application" web page, taxpayers can find information explaining what happens after the application is submitted and benchmarks based on the submission date for whether the application has been assigned for review. Under current procedures, organizations in these situations will receive correspondence from the IRS requesting additional information and therefore will be aware of the status of their application. Requiring the IRS to send additional correspondence in instances where the application is subject to pre-determination or other review may therefore be redundant, consuming resources that otherwise would be available to process cases and handle other taxpayer correspondence.

IMPLEMENTATION DATE:

March 15, 2023

RESPONSIBLE OFFICIAL(S):

Director, EO/GE, TE/GE

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 4:

The Commissioner, TE/GE Division, should: Update the IRS's Charities and Nonprofits website page with accurate information on the application process for Form 1023-EZ filers.

CORRECTIVE ACTION:

TE/GE will update the Application Process page to include the requirements for filing Form 1023-EZ.

IMPLEMENTATION DATE:

March 15, 2023

RESPONSIBLE OFFICIAL(S):

Director, EO/GE, TE/GE

**More Information Is Needed to Make Informed
Decisions on Streamlined Applications for Tax Exemption**

3

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.

Appendix IV

Additional Office of Audit Comments on Management's Response

IRS management's response included some statements that we believe warrant additional comment. We have included portions of management's response and our related comments below.

Management's Response: The IRS determines whether an organization qualifies for exemption under I.R.C. § 501(c)(3) "based solely upon the facts, attestations, and representations contained in the administrative record." Organizational documents are often based upon pro forma drafting to permit the organization to develop and expand its exempt activities within allowable parameters. Prior to the implementation of Form 1023-EZ, the IRS's Exempt Organization Determination staff did not approve the exemption of an organization until the applicant perfected its organizational documents. This added weeks to the application process. Now the IRS accepts the applicant's attestation that the organizational documents meet the requirements under the law. During an examination of an existing exempt organization, examiners may find that an organizing document does not comply with the law. However, this documentary noncompliance has generally not been a reason to revoke the organization's exempt status. If the organization substantially complies with the operational requirements and is operated for exempt purposes, the documentary requirement is generally cured through amendment.

Office of Audit Comment: Even if an organization complies with operational requirements, the law requires it to comply with both operational and organizational requirements. The IRS cannot ensure compliance with the law when approving applications if it does not require organizing documents. The report shows that stakeholder studies, as well as the EO function's own research, have identified hundreds of tax-exempt organizations that potentially do not comply with the organizational test under I.R.C. § 501(c)(3). Moreover, our experience in testing the application process proves that a nonexistent organization, which arguably met neither the organizational test nor the operational test, could obtain tax-exempt status as evidenced by the fact that we obtained tax-exempt status for four of the five organizations for which we submitted applications. While the IRS did flag our fifth application for further review, we withdrew our application at that time and did not engage in further correspondence with the IRS. Tax exemption is not a right but a privilege and should not be approved for the sake of expediency over quality and compliance with the law.

Management's Response: The draft report asserts that streamlining "increases the risk of fraudulent or ineligible organizations receiving tax-exempt status." However, the data referenced in the report do not show an increase in fraudulent applications since 2014, before which all applicants used the long Form 1023. The draft report compares examinations of organizations that received exemption using Forms 1023 and 1023-EZ. The report highlights fewer issues in the case of Forms 1023 based on the no change rate. However, 27 percent and 41 percent of Form 1023 and Form 1023-EZ cases, respectively, resulted in a written advisory rather than a revocation or tax assessed on the organization. Written advisories are used to educate or advise the organization of actions that could, in the future, result in revocation or tax if the organization does not make the appropriate change. Taking into account these relevant

**More Information Is Needed to Make Informed
Decisions on Streamlined Applications for Tax Exemption**

data results in no change rates of 67 percent and 75 percent for Forms 1023 and 1023-EZ, respectively.

Office of Audit Comment: The report explains that fewer barriers increases the risk of approving noncompliant organizations, including fraudulent or fictitious organizations such as the four applications for fictitious organizations that TIGTA submitted and the 23 fraudulent charitable entities alleged by the Brooklyn District Attorney's Office when indicting a man on charges of grand larceny, identity theft, and conducting a scheme to defraud. The IRS examines less than 1 percent of returns filed by tax-exempt organizations each year, so it has no assurance that it did not approve tax exemption for fraudulent organizations or those involved in illegal activities. In addition, the report shows the no change rates as 40 percent for Form 1023 filers and 34 percent for Form 1023-EZ filers based on IRS statistics provided to TIGTA. Historically, the IRS has considered written advisories as "change" cases for statistical purposes even though the examiners took no actions to bring the tax-exempt organizations into compliance or made a tax assessment. For example, the EO Examination unit may issue written advisories for issues potentially having future impact on the organization but not currently causing an issue, such as unrelated business income taxes. As such, we do not think that written advisory cases should be added to the no change rates, which we outlined in our report. TE/GE Division management also advised us that they are discontinuing the issuance of written advisories because no other IRS examination unit engages in this practice. Moreover, the data also showed that examinations of Form 1023-EZ filers were more likely to identify problems with the organizing documents (16 percent) than examinations of Form 1023 filers (6 percent).

Abbreviations

| | |
|--------|---|
| EIN | Employer Identification Number |
| EO | Exempt Organizations |
| FY | Fiscal Year |
| I.R.C. | Internal Revenue Code |
| IRS | Internal Revenue Service |
| PDC | Post-Determination Compliance |
| RA | Revenue Agent |
| TAS | Taxpayer Advocate Service |
| TE | Tax Examiner |
| TE/GE | Tax Exempt and Government Entities |
| TIGTA | Treasury Inspector General for Tax Administration |



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